Approaches to SME Lending in Eastern Europe and Eurasia

Jean Anne Beasley

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Contact jbeas1231@aol.com

Table of Contents

Abbreviations and Acronyms
Executive Summary

I. Introduction and Objectives
- 1.1. Brief Description of Model Approaches
- 1.2. Objectives of Study

II. IPC/IMI Equity Investments in Microfinance Banks
- 2.1 Discussion of Program Characteristics
  - 2.1.1. Role of Technical Assistance
  - 2.1.2. Staffing Configurations
  - 2.1.3. Policies of Equity Positions by IFIs
  - 2.1.4. Capitalization Policy
  - 2.1.5. Business Development Services
  - 2.1.6. Level of Grant Funding
  - 2.1.7. Policy on Cost Recovery and Financial Sustainability
  - 2.1.8. Subsidy Policies
  - 2.1.9. Profitability as Measured by Return on Assets or Return on Investment
  - 2.1.10. Exit Strategies
  - 2.1.11. Other Program Characteristics
- 2.2 Strengths and Weaknesses of the Model

III. Partnering with Commercial Banks
- 3.1. Discussion of Program Characteristics
  - 3.1.1. Role of Technical Assistance
  - 3.1.2. Staffing Configurations
  - 3.1.3. Policies on Equity Positions by IFIs
  - 3.1.4. Capitalization Policy
  - 3.1.5. Business Development Services
  - 3.1.6. Level of Grant Funding
  - 3.1.7. Policy on Cost Recovering and Financial Sustainability
  - 3.1.8. Subsidy Policies
  - 3.1.9. Profitability as Measured by Return on Assets or Return on Investment
  - 3.1.10. Exit Strategies
  - 3.1.11. Other Program Characteristics
  - 3.1.12. Other Program Characteristics
- 3.2 Strengths and Weaknesses of the Model

IV. NGOs with Lending Programs (includes transformations)
4.1. Discussion of Program Characteristics
4.1.1. Role of Technical Assistance
4.1.2. Staffing Configurations
4.1.3. Policies on Equity Positions by IFIs
4.1.4. Capitalization Policy
4.1.5. Business Development Services
4.1.6. Level of Grant Funding
4.1.7. Policy on Cost Recovery and Financial Sustainability
4.1.8. Subsidy Policies
4.1.9. Profitability as Measured by Return on Assets and Return on Investment
4.1.10. Exit Strategies
4.1.11. Other Program Characteristics
4.2 Strengths and Weaknesses of the Model

V. Credit Unions
5.1. Discussion of Program Characteristics
5.1.1 Role of Technical Assistance
5.1.2 Staffing Configurations
5.1.3 Policies on Equity Positions
5.1.4 Capitalization Policy
5.1.5 Business Development Services
5.1.6 Level of Grant Funding
5.1.7 Policy on Cost Recovery and Financial Sustainability
5.1.8 Subsidy Policies
5.1.9 Profitability as Measured by Return on Assets and Return on Investment
5.1.10 Exit Strategies
5.1.11 Other Program Characteristics
5.2 Strengths and Weaknesses of the Model

VI. Leasing
6.1 Discussion of Program Characteristics
6.1.1. Role of Technical Assistance
6.1.2. Staffing Configurations
6.1.3. Policies on Equity Positions
6.1.4. Capitalization Policy
6.1.5. Business Development Services
6.1.6. Level of Grant Funding
6.1.7. Policy on Cost Recovery and Financial Sustainability
6.1.8. Subsidy Policies
6.1.9. Profitability as Measured by Return on Assets and Return on Investment
6.1.10. Exit Strategies

6.1.11. Other Characteristics
6.2 Strengths and Weaknesses of the Model

VII. Direct Equity Investments in SMEs
7.1. Discussion of Program Characteristics
7.1.1. Role of Technical Assistance
7.1.2. Staffing Configurations
7.1.3. Policies on Equity Positions
7.1.4. Capitalization Policy
7.1.5. Business Development Services
7.1.6. Level of Grant Funding
7.1.7. Policy on Cost Recovery and Financial Sustainability
7.1.8. Subsidy Policies
7.1.9. Profitability as Measured by Return on Assets and Return on Investment
7.1.10. Exit Strategies
7.1.11. Other Characteristics
7.2. Strengths and Weaknesses of the Model

VIII. Conclusions

IX. Annexes
A. Comparison Matrix
B. Tables
C. Methodology
D. Contacts and Resources

ABBREVIATIONS AND ACRONYMS

ABK	American Bank of Kosovo
ACDI/VOCA	Agricultural Cooperative Development International and Volunteers in Overseas Cooperative Assistance
BDS	Business Development Services
BIO	Belgian Investing Company for Developing Countries
DEG	Deutsche Investitions – und Entwicklungsgesellschaft
DFID	Department for International Development, UK
DOEN	Foundation DOEN
EE	Europe and Eurasia
EGAT	Bureau for Economic Growth, Agriculture, and Trade
EBRD	European Bank of Reconstruction and Development
GDP	Gross Domestic Product
FINCA	Foundation for International Community Assistance
FMO	Netherlands Development Finance Company
IESC	International Executive Service Corps
IFC	International Finance Corporation
IFI	Intermediary Financial Institution
IPC	Internationale Projekt Consult
IRR	Internal rate of return
KBFF	Kosovo Business Financing Fund
KfW	Kreditanstalt fu Wiederaufbraw
MEB	Micro Enterprise Bank
MFB	Microfinance Bank
MFI	Microfinance Institution
MIS	Management information system
MSME	Micro, small and medium enterprise
OI	Opportunity International
OMF	Opportunity Micro Credit Fund
OTI	Opportunity Transformation Investments
RIB	Raifeisen International Beteiligungs
ROA	Return on assets
ROE	Return on equity
ROI	Return on investment
RZB	Raiffeisen Zentralbank Osterreich
SAS	Shorebank Advisory Services
SEAF	Small Enterprise Assistance Funds
SECO	Swiss Government's State Secretarial for Economic Affairs
SME	Small and Medium Enterprise
TA	Technical Assistance
TC	Technical Cooperation
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

The purpose of this report is to review lending approaches used by donors in Europe and Eurasia to support micro, small and medium enterprises (MSMEs) so that they can be compared based on specific characteristics of each approach. Six widely used approaches are discussed and developed as models. They are as follows: 1) IPC/IMI equity investments in microfinance banks (MFBs), 2) partnering with commercial banks, 3) best practice NGOs, 4) credit unions, 5) leasing, and 6) direct equity investments in SMEs. Specific program characteristics addressed under each model include 1) the role of TA, 2) staffing for loan programs, 3) BDS provided to clients, 4) policies on equity positions by IFIs, 5) capitalization policy, 6) level of grant funding, 7) policies on cost recovery and financial sustainability, 8) subsidy policies, 9) profitability as measured by ROA and ROI, 10) outreach, 11) savings, and 12) exit strategies.

This study finds that each of the models has particular strengths, and its appropriateness depends on the specific target clients, country and market conditions. For example, both best-practice NGOs and the IPC/IMI MFBs employ methodologies designed to quickly establish functioning institutions. However, they rely heavily on donor grants or long-term capital in equity shares for start-up. Institutions with savings deposits, have a lower cost of funds for their loan portfolios and this is a reason why NGOs sometimes transform themselves into banks. Leasing is especially appropriate in countries like Russia where the lack of access to medium or long-term loans makes three to five year leases attractive to formal-sector SMEs that pay taxes. Direct-equity investments in SMEs are effective for supporting small businesses with high growth potential, which, when mentored by investment analysts from equity funds and provided with intensive BDS, can grow into medium enterprises.

All of these models aim for profitable performance and focus on specific indicators when reporting performance. For example, the IPC/IMI model emphasizes return on equity (ROE), while NGOs and credit unions report return on assets (ROA). The profitability of SME lending through commercial banks is more difficult to measure because, with a few exceptions, they tend not to disaggregate return on portfolio and return on assets by type of loan. Allocating costs to specific segments of portfolios would be tedious and donors who partner with commercial banks tend not to want to increase bank workloads. These banks do report on numbers and amounts of loans disbursed with specific lines of credit and arrears, but do not routinely track income or costs from these loans. Accordingly, amounts disbursed and arrears become results indicators to donors. Leasing companies are for-profit businesses, but donors who support this sector review sector growth as reflected in volume of portfolios rather than returns for individual companies. Administrators of equity investment funds track the gross IRRs of investee companies and multiple returns on capital, which are of interest to fund shareholders. Performance indicators (presented in Annex B) show positive returns for almost all institutions except

those recently established,[1] those which operate in unfavorable environments, and those that have not yet reached a critical mass of clients.

Grants are used by all the model approaches to fund initial TA and operating expenses. When reporting profitability, grants are not added to the investment or costed against profits. Donors may not be able to track grant funding from other sources to institutions, they support. This makes it difficult to determine the true cost of an investment for institutions, which may have several sources of funding. Instead, donors look at grants as a sunk start-up cost, and if the institution(s) they support perform well after the technical assistance phase is completed, then a project is viewed as a success. Also, in on-going institutions, grant financing is not expected to last for more than a certain time, so its impact on long-term profitability can be expected to decrease as an institution becomes more sustainable. When sufficient information is available to calculate ROI, as in the IPC/IMI model, returns are smaller than ROE by the proportion of grant funded TC over total investment. For example, the ROE for MEB Kosovo before accounting for TC grants is 50% and ROI decreases by 29.5% (the amount of TC to total investment) to 35.2%. Institutions may wish to cost out TC grants themselves, so that they can more accurately monitor profitability.

Exit strategies vary according to model and investment methodology. In some programs with equity investors, the exit policy is for investors to sell shares. However, sometimes shareholders purposefully have no exit strategy (IMI/IPC, transformed NGOs) because they want to maintain presence to influence governance of an organization and to assure that target clients remain the same. In other models (commercial banks, credit unions, and leasing) TA timeframes set up the parameters for active donor participation and when they end, exit occurs. Sometimes, the terms of an IFI loan or program support agreement will guide the exit of a donor.

Finally, the context of this study is preliminary since many of these institutions are not yet sufficiently mature to show stable, definitive results. Comparable institutions and programs should be at the same level of maturity and in similar country settings to facilitate confident, realistic comparisons. Quantitative and qualitative results can then be compared to determine to the most appropriate model to use for achieving specific objectives.

[1] Not expected to reach profitability until year 3

I. Introduction and Objectives

Small and Medium Enterprises (SMEs) have been recognized as a critical economic sector because of their contribution to employment and GDP. A 2002 report indicated that in the European Union SMEs contributed 72% to overall employment and 63-67% to GDP.[2] In Poland these figures are to 63% and 48%, respectively, and in Russia, are on the order of 10%. Most donors and multilateral development organizations agree that a vibrant SME sector strongly contributes to economic growth and accordingly, support several approaches to business financing. These approaches include: 1) establishing and supporting banks geared towards micro and small businesses; 2) supporting NGOs which lend to the sector; 3) working with commercial banks; 4) strengthening credit unions; 5) developing the leasing sector; and 6) investing directly into SMEs, either through equity or debt or both. Approaches depend on many factors, including: 1) the country setting and its macroeconomic conditions; 2) the level of development of the banking sector; 3) the policy environment; 4) specific characteristics of the sector; 5) availability of donor funding; and 6) private investment funding.

1.1. Brief Description of Model Approaches

This report provides an overview of some of the major approaches used in SME financing and some indicators that facilitate comparisons. Although the focus is on SMEs, the micro enterprise sector is also included, since many institutions serve both micro and small enterprises, and the defining lines between the two tend to converge as these enterprises grow. Six models, or approaches, used to finance Micro, Small and Medium Enterprises (MSMEs) are presented and discussed in terms of specific criteria. A brief description of each of these models follows.

Equity investments in microfinance banks have been used to establish MFIs all over the world using what has become known as the IPC[3] methodology. In Eastern Europe there are at present nine of these banks (March 2003). They have been set up with equity positions from the IMI and other investors, and offer financial services and products to micro and small entrepreneurs.

Commercial Banks may partner with investors, multilateral banks and donors that offer TA, lines of credit for on-lending to SMEs, and sometimes incentives for entering the SME market.

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[2] *Source: Dresdner Kleinwort Wasserstein – Bloomberg Sachs Russia and CIS Conference, March 2002* as reported in International Finance Corporation/Leasing Development Group, *Financial Leasing in Russia Market Survey 2001-2002*, Moscow, 2002.

[3] Internationale Projekt Consult - a German micro-finnance technical assistance foundation, which in 1998, joined with the IFC, the DOEN Foundation, FMO, KfW, DEG and ProCredito Bolivia to form the IMI, an investment company, which takes equity stakes in microfinance institutions.

NGOs often establish lending programs that are targeted to micro or small businesses. However, as client needs grow, loans become larger and NGOs may transform themselves into banks.

Credit Unions are established to serve their members as both deposit-taking and lending institutions. Savings are one source of financing for loans, although when the demand for loans is greater than deposits, other sources or credit may be sought. Donor support for these institutions generally is focused on providing TA to strengthen financial operations so that credit unions can improve performance. Loans tend to be small.

Leasing is an alternative strategy to finance SMEs, especially in environments where credit availability and payback terms do not match the financing needs of the entrepreneurs. Equipment is usually rented over three to five years at charges competitive with bank lending rates.

Direct Equity Investments in SMEs is a methodology that targets enterprises with strong growth potential, providing intense management and development assistance, often paid for, at least in part, by the investee. The investments may both have equity and debt components, but returns are not normally realized until exit when the investor's shares are sold.

1.2. Objectives of Study

The objectives of this study are to discuss the various financing models listed above in the context of their appropriateness for specific markets. Specific program characteristics are addressed, as are strengths and weaknesses of each model.[4]

Program Characteristics:

- **Role of technical assistance** refers to assistance provided to financial institutions (or, in the case of leasing in Russia, broad-based TA to develop the leasing market) as opposed to business development services, which are provided directly to entrepreneurs;

- **Staffing configurations** refers to the institutional personnel, especially loan officers needed to implement the program

- **Policies on equity positions by IFIs** refers to how shareholders invest in banks or MFBs

- **Capitalization policy** refers to how loan portfolios are capitalized, or the sources of investment capital for direct equity investments or the establishment of leasing companies;

[4] Program characteristics are summarized by model in the matrix in Annex A. Tables showing indicators to measure profitability, portfolio quality, investments, savings, outreach and loan characteristics are in Annex B.

- **Business development services** offered to clients refers to how lending institutions or investment funds offer or facilitate such services for the entrepreneurs;

- **Level of grant funding** refers to the use of grants to fund financing programs as opposed to loans and for what purposes grants are used;

- **Policy on cost recovery and financial sustainability** refers to policies governing operational and financial self-sufficiency and sustainability when these institutions must rely fully on market financing;

- **Subsidy policies** refer to built-in subsidies both for the lending/financing institutions and for the end users;

- **Profitability as measured by return on assets or return on investment** – when this information is available, it is calculated and noted in the report; alternative profitability indicators are noted (see Annex B);

- **Exit strategies** refer to how or whether investors, stakeholders, or donors plan to close-out their participation in specific activities and organizations;

- **Outreach** refers to the number of clients, size and distribution of loans;

- **Savings** refers to the savings deposits accepted from clients.

II. IPC/IMI Equity Investments in Microfinance Banks[5]

Equity investments in microfinance banks refers to a model developed by Internationale Projekt Consult (IPC), a German microfinance technical assistance provider, which had worked with the IDB, EBRD, GTZ to support microfinance institutions, mainly in Latin America and the former Soviet Union, as a consultant. In 1996 the IPC took a decision to become an investor rather than a mere consultant, taking equity positions in new microfinance banks in order to effectively address governance issues through management control, and better develop these institutions into commercial for-profit banks. In 1998 the IPC formed an investment company, the Internationale Micro Investitionen Aktlengesellschaft (IMI), along with other organizations which shared its philosophy. These shareholders are the IPC-Invest, the DOEN Foundation and FMO of the Netherlands, the KfW/DEG of Germany, the BIO of Belgium, ProCredito of Bolivia and the IFC.[6] Each of these investors adds value to the IMI not only by pooling financial resources, but by the specific skills and experience they bring to the organization. Furthermore, apart from the IMI investment, they often take out additional equity positions in microfinance bank.

The IMI shareholders share the premise that banking services targeted to micro and small entrepreneurs can be profitable when they are provided through institutions that receive appropriate technical assistance and have a solid equity base. The model is predicated on the assumption that a profitable, high-impact commercial MFI can be created in about three years in almost any environment with \$1 million to \$3 million in equity and approximately \$1.5 million in technical assistance grants. The targets are to achieve a return on equity (ROE) of 10-15% after three years and 20% after eight years.[7] In Eastern Europe, as of March 2003, there were nine microfinance banks established between 1997 and 2001. They are the MEB/Bosnia & Herzegovina, MBG/Georgia, FEFAD/Albania, MEB/Kosovo, MFB/Ukraine, MIRO Bank/Romania, MEC/Moldova, MFB/Serbia, and ProCredit/Bulgaria.

The implementation of the business strategy to establish banks is planned in four phases. During the selection phase a country of interest is selected, a market study carried out and a business plan developed. The establishment phase consists of securing the initial investment capital (usually from € 5 million to € 10 million in Eastern Europe), lining up TA, and securing a banking license. The institution phase after start-up consists of intense TA, building local skills, expanding branches and building the loan portfolio. The fourth stage is aimed at achieving sustainable operations, expected by the third year of operations, and tracked by return on equity (net profit over equity, excluding grants for TA as part of the investment).

2.1. Discussion of Program Characteristics

[5] Also known as the IPC/IMI methodology
[6] The proportion of IMI shares owned by each organization are as follows: IPC GmbH – 20%, IPC-Invest GbR – 10%, DOEN – 20%, KfW/DEG – 12%, ProCredito – 2%, IFC –12%, FMO – 12%, and BIO – 12%.
[7] www.imi-ag.de

2.1.1. Role of Technical Assistance

Technical assistance to a microfinance bank is a critical element of this model. During the first two years, intensive training is provided by experts who come into a bank or by sending staff to other IPC/IMI banks, or even using expat professionals as senior managers. The IPC introduces its own software as part of the TA, and adapts a variety of loan products to specific banks. Lending begins within six to eight weeks. These same techniques are used to train branch personnel since rapid branch expansion is another characteristic of the model. TA grants fund the acquisition of fixed assets, which are written off as soon as possible rather than being added back to equity (except as local rules require otherwise). Expertise is provided by long and short-term advisors in areas such as credit, information technology, and loan officer training. TA grants typically pay stipends of staff being trained. Funds expended on TA are not included when calculating return on equity. Once a microfinance bank reaches a reasonable level of sustainability, both operationally and financially, it is graduated from TA. The goal for graduation is three years, although it may take longer.

2.1.2. Staffing Configurations

Staffing consists primarily of loan officers who make site visits to local businesses. Figures as of January 2003 show 621 loan officers and 74,127 loans[8] in nine banks in Eastern Europe.[9] This works out to about one loan officer for every 120 clients, lower than in Latin American IPC/IMI MFBs where the average is one loan officer for every 321 clients. Factors influencing staff size include dispersion of clients, expansions and number of branches. Loan officers are paid using incentives based on the size of their portfolio and arrears.

2.1.3. Policies on Equity Positions by IFIs

The IMI takes a permanent position in equity, that is, it maintains majority shares in an MFB so that it can control governance. However, policies of secondary shareholders[10] are generally different because they hold positions for the medium-term, or "demonstration phase," typically five to seven years. IFIs such as the IFC have policies that prevent them from becoming the majority shareholder. When partner shareholders sell their equity positions, the IMI's policy is to buy sufficient shares to maintain its position as majority shareholder. Other shares could be purchased by other partners (15-25%), private investors or sold on the stock market. The sale of a complete bank to a third party shareholder might be acceptable as long as the buyer could demonstrate that it would adhere to the target client group of the bank.

2.1.4. Capitalization Policy

Initially the loan portfolio is capitalized by the equity investment. As institutions grow, savings deposits and lines of credit extended by IFIs such as the EBRD and commercial banks are used to capitalize loan portfolios. As regulated financial institutions, the

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[8] A proxy for number of clients

[9] As reported at www.imi-ag.de/stat

[10] In Eastern Europe thee include the KfW Group, IFC, FMO, DOEN Foundation, EBRD and Commerzbank

microfinance banks are also able to leverage their equity to obtain additional funds as needed.

2.1.5. Business Development Services

The microfinance banks described under this model do not offer business development services (BDS) directly to their clients. Loan officers may offer informal advice to clients, or refer them to other organizations, which specialize in such services.

2.1.6. Level of Grant Funding

Grant funding pays for technical cooperation (TC) and is drawn from both the US/EBRD SME Facility and from other donors who co-finance TC as a pre-requisite for U.S. eligibility. The EBRD reports on disbursements from the US/EBRD SME Financing Facility, but it does not report on TC disbursements from co-financing donors - only on commitments. Accordingly, it is difficult to ascertain for certain the exact level of grant funding to an institution from all sources. To estimate the contribution of TC to total investments for this report, disbursements were added to commitments and the total was then added to equity. (See Table 1) Under IPC model parameters, approximately one third of the total initial investment corresponds to TC, but in calculations for the nine IPC/IMI banks, the range was 8.9% to 56.2%. Factors, which might influence these proportions, include the age of the bank, whether or not it is a greenfield or an on-going financial institution, the business environment, branch expansions, etc.

2.1.7. Policy on Cost Recovery and Financial Sustainability

Microfinance banks financed with IMI equity are expected to achieve operational and financial sustainability by year three. The first year, about 90% of the operational costs are paid for by grants. The second year, this is reduced to about 50%, and the third year is breakeven with a target ROE of 15%. This may be somewhat ambitious, as the EBRD reports that all microfinance banks except MEB Kosovo received some grant funding in 2002, including MEB Bosnia, which was established in 1997 (see Table 1). The remaining banks were established from 1999 to 2001, so not enough time has passed for them to become self-sustaining. The test will be to continue tracking these institutions and the TA disbursements to determine how long they actually continue compared to the target period in the model.

2.1.8. Subsidy Policies

Technical cooperation is subsidized and continues until a bank reaches a level where it can cover its operational and financial costs and earn a reasonable return on its equity. These subsidies decrease each year and are expected to phase out after sustainability and profitability are reached. In fact, the only banks reported as reaching this level in September 2002[11] were those of Kosovo and Albania, that had reached ROE's of 50% and 12.3%, respectively, after operating about three years.

2.1.9. Profitability as Measured by Return on Assets or Return on Investment

[11] Annex 23 US/EBRD SME Financing Facility Technical Co-operation Projects, September 30, 2002

The IMI reports profitability at net income after taxes over equity, ROE. Grant-financed operating expenses are not subtracted from surplus and accordingly, net profit may be overstated in the early years while bank operating expenses are subsidized. Many NGOs with micro-finance programs report self-sufficiency with grants and without grants. In the case of a greenfield bank, one can consider the initial grant financing as part of the investment costs of setting up the business. If this method is used, grants can be added to equity to calculate total investment and then net profit can be calculated as a return on total investment. As grants are phased out and equity generated by retained earnings grows, the impact of grants in early years will decline.

Profitability was calculated as ROE, ROA (return on assets) and as return on investment (see Table 2, Annex B). Net profit was also calculated over average portfolio and average assets. The range of ROE using 2002 year-end figures was from a negative 19.2% in Serbia where some large one-time deductions were taken, to 50% in Kosovo. The median ROE for banks functioning at least three years was 9.6%. Return on total investment for banks functioning at least three years was 6.9%. Corresponding figures for return on average assets and average portfolio were 1.5% and 4.8%, respectively, (see Table 3 Annex B). Arrears are a measure of portfolio quality, and ranged for all MFBs from .06% to 3.4%. Benchmark figures for 147 microfinance institutions tracked by the Micro Banking Bulletin are presented in Table 6 Annex B. These figures indicate that financially self-sufficient for-profit MFIs functioning for an average of ten years had an average ROE of 20.5%, an ROA of 3.9% and a gross yield on portfolio adjusted for inflation of 30.4%. Since IMI/IPC microfinance banks in this study only had an average of 3.1 years functioning, the returns are not comparable yet, but can be used in future years for comparisons.

2.1.10. Exit Strategies

The IMI plans to maintain its majority shares over the long term to ensure that the microfinance banks remain focused on target clients of micro and small entrepreneurs. Other shareholders, however, may exit by selling their shares to the IMI, to other partners or even by floating shares on the stock market. Donor grant funding to provide TC during start-up is phased out as banks become profitable.

2.1.11. Other Program Characteristics

Outreach is measured by tracking the number of clients, the size of loans, both average and by distribution. Micro loans made under the Facility are defined as loans extending up to $10,000 and small loans up to $100,000. Distributions in Table 4 Annex B indicate a reverse relationship between number of loans and amount of loans. Most clients (usually over 80%) have loans of less than $10,000, yet the amount outstanding of this category of loans totals less than 50% of the total outstanding portfolio. The number of clients with small loans ($10,000 to $50,000) ranges from 6 % in Georgia to 26% in Serbia and a mere 1 - 2% of clients of each bank have loans of over $50,000. One would expect larger loans to become more prevalent as entrepreneurs grow their businesses.

Customer savings deposits trail loan portfolios in all banks except for Kosovo where they are more than ten times larger (see Table 1 Annex B). The unique situation of Kosovo is explained by the time and conditions under which the bank was established. MEB Kosovo was the only registered bank in Kosovo right after the war of 1999 and this period also corresponded to the Euro conversion in January 2000. Accordingly, many Kosovars were motivated to place their money in savings deposits in a bank where it could be converted. Also, many Kosovar Albanians worked in other countries prior to the war and often kept their savings out of the country. However, after the war many returned home with their savings, which they deposited in MEB Kosovo, - thus the very large discrepancy between the amount in savings deposits and that in the loan portfolio.

2.2 Strengths and Weaknesses of the Model

This model is ideal for efficiently establishing a new bank targeted toward smaller and micro entrepreneurs and quickly having it up and running, making loans and showing profitability. Moreover, statistics relating the banks and their performance are transparent and easily accessible on the IMI web site so that profitability can be tracked. For example, the MFB Serbia showed a small profit for the month of February 2003, less than two years after it was established.[12] These banks also have outreach to a large number of clients in part due to the practice of establishing branches early-on. The focus is on profitability and achieving an ROE that will attract investors. However, in early years profitability as measured by ROE is over stated in that expenses funded with grants are not deducted from income.

This model is premised on investors having the necessary funding and their willingness to keep their investments for the medium to long-term. Each time the IMI wishes to establish a new microfinance bank, it must have sufficient funding for a long-term investment and identify partners with a shared vision who are willing to make such investments. Furthermore, the target client is the micro to small entrepreneur and one can only assume that loans will scale up as businesses grow. However, only more time will demonstrate whether banks in this model will effectively finance medium enterprises.

[12] Profit before tax in Euros for the month of February 2003 was €151,446

III. Partnering with Commercial Banks

This model consists of channeling loans through commercial banks to SMEs and occasionally micro enterprises, usually with donor support via TA, and lines of credit.[13] The Caucasus SME Finance Program (1998-2002) implemented by Shorebank Advisory Services (SAS) in Armenia, Azerbaijan and Georgia worked through commercial banks and focused both on small enterprise loans greater than $10,000 and DEL bridge loans, $1,000 to $10,000, (bridging the gap between micro and small). The EBRD EU Accession Program has focused since 1999 on bank entry into the SME market in ten EU Accession countries[14] with 26 bank partners by providing TA and lines of credit with performance fees as market incentives. The US/EBRD SME Financing Facility has supported SME and micro lending in Georgia, Kazakhstan and the Kyrgyz Republic via TA and lines of credit. Usually SME lending becomes part of a credit operations department in a partner bank. USAID/Kosovo's establishment of a commercial bank is a hybrid described under this model, because it draws on elements of the equity investment model described in Section II and also involves direct assistance to a commercial bank aimed at SMEs. The USAID Mission in Kosovo set up a new bank by supporting two organizational components the first year, the Kosovo Business Finance Fund (for lending)[15], and the American Bank of Kosovo (ABK), a full-service licensed bank founded in 2001, into which the lending unit was merged in 2002. This bank was sold to a western foreign bank, the Raiffeisen Zentral Österreich in December 2002, and its name was changed to the Raiffeisenbank Kosovo during the first quarter of 2003.

3.1. Discussion of Program Characteristics

3.1.1Role of Technical Assistance

Technical assistance to banks entering a new market is key to the success of this model. It is provided to lending departments at commercial banks via short and long-term experts and at training seminars and workshops. Training in all the programs focuses on a number of common topics including credit risk management, cash flow analysis, financial statements, lending techniques and processes, cost accounting, risk analysis, and collections. The EU Accession program emphasizes a sales oriented approach focused on direct marketing, customer calling as well as training topics mentioned above. Its TA program is designed to last two years. The SAS Caucasus program trained all personnel in one Georgian bank from top management on down, and at the end of the program the bank bought the SME/DEL loan portfolio. SAS issued quarterly report cards that analyzed the banks lending and made recommendations for improvements. The US/EBRD SME Facility finances TA via grants to partner banks in Georgia, Kazakhstan and the Kyrgyz Republic. Expat consultants may form part of the bank's management during training. For example, the training team for the KBFF/ABK consisted of ten Western expat consulting experts in banking, and lending who worked in operations

[13] Results of these programs are provided in Tables 8-12 in Annex B
[14] Czech Republic, Slovakia, Hungary, Poland, Slovenia, Latvia, Lithuania, Estonia, Romania, Bulgaria
[15] SME loans, the focus of this institution, are defined as from € 20,000 to 50,000.

while they trained. Stipends often are paid to local loan officers and branch management during the training period.[16]

3.1.2. Staffing Configurations

Since SME lending programs are usually incorporated into programs of already functioning banks, incumbent bank management itself determines staff configurations and identifies which departments will implement SME lending. This organizational structure is influenced by the size of the bank. For example, in the EU Accession Program, the functions are usually incorporated into the business lending departments of smaller banks and into the retail credit departments of larger banks. Retail credit departments are typically headed by a vice president, who then appoints an SME manager to whom managers of branches (where most of the SME lending is done) report. Staffing configurations in banks supported by the US/EBRD SME Facility indicate that the number of clients per loan officer tends is lower than in microfinance banks because there are fewer clients and potential loans require more analysis. In Kazakhstan the number of clients per loan officer was about 49, while in Georgia it was 25, and in the start-up Kyrgyz Republic it was 3[17]. Banks participating in the SAS programs hired 49 new staff for these programs along with existing staff.[18] The KBFF/ABK drew on ten expat consultants who trained 141 local staff (27 in lending operations) during its set-up.[19]

3.1.3. Policies on Equity Positions by IFIs

Taking equity positions in commercial banks by IFIs is much less common than taking equity positions in microfinance banks under the IPC/IMI model in which equity is a defining component. For example, the IFC has only made one equity investment in a bank in Russia and it specializes in retail. When the IFC takes an equity position, it has an exit strategy, typically a put option, signed concurrently with the agreement. USAID planned to sell its shares in the ABK during its third year of operations to a Western bank, although when the support program began in May 2001, no buyer had been identified.

3.1.4. Capitalization Policy

The commercial bank partner SME programs presented in this study were capitalized with lines of credit from IFIs, although banks do begin to use their own capital as positive results become apparent. Portfolios in the EU Accession Program are funded with an EBRD line of credit, of which €344.7 million have been disbursed. Partner banks under the US/EBRD SME Financing Facility are funded with an EBRD line of credit, which has disbursed $259.3 million in Kazakhstan, $1.59 million in Georgia and $.24 million in Kyrgyztan. SAS used lines of credit from the IFC and grants from USAID to fund loans (for complete disbursals see Table 12, Annex B). USAID funds in the SAS program were leveraged with a high level (i.e. 90%) of investment funds from profit oriented local and international investors. Loan funds are also capitalized with re-investment of

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[16] This is documented for banks supported under the US/EBRD Financing Facility
[17] Reported in the US/EBRD SME Financing Facility Semi-Annual Report, September 2002
[18] Total number of loan officers implementing the SME/DEL programs was not available.
[19] Deloitte, Touche, Tohmatsu,. "Study of Innovative Practices in SME Finance," September 30, 2002, Chapter 1.

retained earnings and from savings deposits. Terms of loans via lines of credit vary depending on country and assessments of the banks receiving the credit.[20]

3.1.5. Business Development Services

These services are generally not offered by commercial banks, although SAS did design some courses for entrepreneur clients, including how to approach banks for loans.

3.1.6. Level of Grant Funding

Grants are used to fund TC/TA costs, including some stipends, and long and short-term consultants. This reduces operating costs of lending activities during initial years. The EBRD EU Accession program has disbursed € 18m out of a total of € 27m approved as opposed to € 344.7 for the loan program, a ratio of 5%. Disbursements of grants from the US/EBRD SME Facility for TC in proportion to loan funds disbursed ranged from 25% in Georgia to 7% in Kazakhstan to 431% in the start-up phase of the Kyrgyz Republic[21].

3.1.7. Policy on Cost Recovery and Financial Sustainability

Commercial banks are driven by markets and returns, and accordingly, they would not continue to work with the SME sector is it were not profitable. Programs described in this report help finance costs until the lending operations are operating smoothly. Unlike a newly established bank or NGO with a lending program, these are on-going for-profit institutions which will not continue with unprofitable products or operations. As competitor banks not supported by this program (especially foreign) have entered the market, this has motivated banks in the program to use their own funds for sustainable lending.

3.18. Subsidy Policies

Technical assistance to train bank staff is subsidized under all the lending programs. The EBRD EU Accession Program offers a declining performance subsidy that phases out after three years. This consists of a 5.5% fee based on the outstanding portfolios of loans up to €30,000 and 3.5% on loans from €30,000 to €50,000. After three years the phase out of fees begin as they are reduced by 50% each year up to five years, when they are eliminated. Banks do not pass these subsidies on to their borrowers; they are subsidies used as incentives for banks to downscale and move to a new SME market. Banks supported by the US/EBRD SME Facility and under the SAS program receive lines of credit from IFIs (at the normal rates charged by these intermediaries) for on-lending to clients.

3.1.9. Profitability as Measured by Return on Assets or Return on Investment

Traditional methods for measuring profitability for SME lending are difficult to calculate because commercial banks tend not to disaggregate their portfolios by size of loan or

[20] For example in Georgia, interest rates on lines of credit from IFIs range from 6-7%.
[21] As reported in the US/EBRD SME Financing Facility Semi-annual Report September 2002; co-financing disbursements not reported

sector.[22] Accordingly, returns measured in this way could only be tracked for a few banks. (see Tables 7-9). Multilateral banks such as the EBRD track loan disbursals and arrears as proxies for measuring returns and the profitability of bank portfolios (see Tables 8 and 10). If arrears are low and loan disbursals are increasing, the assumption is that the portfolios are profitable. The few cases in which it was possible to calculate ROE and ROA show a range of from 4% to 11% and from 4% to 6.1% respectively. Shorebank is used as a benchmark with an ROE of 17% and an ROA of 1.2%.

3.1.10. Exit Strategies

Programs are set up with commercial banks for specific time durations. When SAS successfully exited Georgia, its portfolio was sold to an implementing bank. SAS has still not, however, determined an exit strategy for Azerbaijan where its program is operationally, but not financially, self-sufficient. The EBRD EU Accession Program uses its phased out performance fee approach and its two-year TC program as its exit strategy. Partner bank programs supported with the US/EBRD SME Financing Facility are scheduled to accomplish training objectives and when TC funds are used up, bank staffs will have been trained to carry out programs without donor assistance. If an IFI extends a line of credit, the loan terms become the exit strategy. USAID's exit strategy in Kosovo was to sell the ABK in December 2002 to Raiffeisen International Beteiligungs AG (RIB), a subsidiary of the RZB Group based in Vienna.

3.1.11. Other Program Characteristics

SME lending channeled through commercial banks is not designed to reach as many clients as micro lending because loans are larger and the pool of qualified businesses is smaller. (See Tables 10-12, Annex B) Special techniques may be used to make loans available to clients without sufficient collateral. For example, guarantee programs may be used for special purposes such as for start-up businesses or in depressed areas. Warehouse receipts can also be used as collateral for agro-business loans whereby farmers can deposit their harvest and receive receipts, which are accepted by banks to meet collateral requirements. This system has advantages because it creates storage for commodity owners, facilitates the transfer of commodities to buyers, and provides collateral for commercial bank lenders.

3.2. Strengths and Weaknesses of the Model

Selection of participating banks is key to a strong model because if partner banks decide after donors exit not to continue lending to the SME market, then TA has been wasted. The EBRD in the EU Accession Program has tried to select a variety of banks, both large and small and has found that whereas loan volume is most efficient in small banks, big banks have a national market impact. SAS had mixed results working with a number of banks and had to drop several, which were not performing adequately. The strength of this model is demonstrated when a bank's management and shareholders buy into the

[22] This was confirmed by the managers of EBRD credit program, the financial sector expert in Kazakhstan,, and several commercial banks. The only banks contacted that were able to disaggregate portfolios by SME and Micro loans were the Bank of Georgia and the Tbiluniversal in the Republic of Georgia.

strategy and incorporate it into their long-term business plans, thus leading to its institutionalization and long-term sustainability.

IV. NGOs with Lending Programs (includes transformations)

Best practice NGOs that serve the micro and small business sector can be defined as those, which have achieved or are striving for operational and financial sustainability, use positive market interest rates and have outreach to a critical mass. Usually they do lending rather than savings because as NGOs, they are often subject to prohibitions and regulations against accepting customer savings deposits. In this model NGO affiliates are typically established with donor grants that cover start-up costs and may at least partially, capitalize the loan portfolio. The most successful may consider transforming themselves into banks, because as regulated financial institutions they can establish savings deposits and leverage their equity to access more capital for loans.

4.1. Discussion of Program Characteristics

4.1.1 Role of Technical Assistance

Best-practice NGOs have experience and well-developed methodologies and experienced practitioners to train staff personnel in new affiliates. Typically, training is carried out either by staff members from an existing affiliate who visit the new office or by sending new staff to operating affiliates for training there. This allows the NGO to capitalize on knowledge within the system. Expat managers may help set up new offices and stay on for up to 3 to 4 years. NGOs may have their own global consulting groups of both full and part-time consultants who are specializing in microfinance and banking issues. Specific training for credit officers tends to vary by country affiliate, but NGOs may use regional or national offices to carry out specialized training such as MIS. Initial TA is generally covered by grants.

4.1.2. Staffing Configurations

The ratio of loan officers depends on the loan product, i.e., group versus individual, and whether the setting is rural or urban. It can range from about 100 to over 200 clients per officer. Accounting department operations are separate from lending operations and may even report directly to a regional hub.

4.1.3. Policies on Equity Positions by IFIs

Generally, IFIs do not invest in NGOs, although there may be some exceptions.[23] If affiliate NGOs transform into commercial banks, then the international NGO would take a shareholder position, probably a majority, to control governance issues. Other IFIs might enter at that time and also take positions.[24]

4.1.4. Capitalization Policy

Initially the loan funds are capitalized with grants, but as demand grows, country directors may access commercial financing. NGOs cannot act as intermediaries to mobilize savings. Group members may informally use their own savings as an extra

[23] FINCA and the IFC formed a for-profit joint venture (FINCA Microfinance Resource) with the IFC with shares of 60% and 40% respectively. Funds from this venture were invested in FINCA Kyrgyzstan. IFC's profit share was capped at 12%.

[24] OI has two subsidiaries, Opportunity Transformation Investments (OTI) in the U.S. and Opportunity Microcredit Fund (OMF) in the UK which plan to invest about $18 million in equity in 10 MFIs worldwide

source for loan funds, but the NGO does not mediate. Retained earnings are typically reinvested in the loan portfolio. Portfolios may also be capitalized with interest bearing lines of credit from IFIs.[25]

4.1.5. Business Development Services

NGOs tend not to offer formal BDS as paid services when their focus is financial services. Some may offer services that benefit clients or establish formal relationships with organizations, which offer BDS.[26]

4.1.6. Level of Grant Funding

When a new country affiliate of an NGO is set up, it is usually with donor grant funding. About 30-35% is for start-up costs (including expat salaries) and the rest is to capitalize the loan portfolio and form the equity of the organization.[27]

4.1.7. Policy on Cost Recovery and Financial Sustainability

Best practice NGOs target operational sustainability within two years and financial sustainability in 4 to 6 years (see Tables 13-14). This does not include the costs of expat managers.

4.18. Subsidy Policies

Expat salaries in new affiliates are subsidized. OI has an expat management team from two to five years, but will only subsidize salaries three to four years at most. All other local operational costs are covered with income generated by the program. Start-up costs include hiring and training staff, acquiring fixed assets, rent etc. and these are covered by the initial grant. Funds are lent out at unsubsidized rates.

4.19. Profitability as Measured by Return on Assets and Return on Investment

Profitability is carefully tracked and typically NGOs can report on a monthly basis what proportion of both financial and operational costs are covered. If they receive grants, it is typical to report on self-sufficiency with and without the grants. Profitability ratios are shown on Tables 13 and 14 and ROA ranges from negative 5% in a new OI start-up affiliate in Serbia to 6.5% in Russia. The Montenegro affiliate reached 8% in 2001 before its transformation to a bank in 2002, a year in which extraordinary conversion costs reduced ROA to negative .5%. FINCA affiliate ROAs range from a negative 5% to 27% in Kyrgyzstan which is programmed for transformation to a bank by 2005.

4.1.10 Exit Strategies

Exit strategies include transformation of NGOs into banks or regulated financial institutions, although primary NGOs will maintain relationships with affiliates as equity

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[25] FINCA/Kosovo received two lines of credit from the KfW, one for 18 months and one for 60 months with an origination fee of .25% and annual interest of 3%.

[26] FINCA offered a tax help phone line to clients in Georgia. OI affiliates have established formal relationships with fee charging BDS centers.

[27] OI has made grants to loan funds of its affiliates from private sources equal to about 25% of USAID grants.

shareholders to assure that transformed institutions continue to follow established methodologies and serve target clients. Best practice NGOs have transformed or plan to transform affiliates.[28] When making transformation decisions, NGOs considers the regulatory environment, demand for capital, and performance of the affiliate considered for transformation.

4.1.11. Other Program Characteristics

Outreach in the microfinance NGOs depends on the country environment, and tends to reach more clients when a village banking or group methodology is used with very small loans than when more individual larger loans are offered (see Tables 13-14). Although there may be a future trend towards transformations, there are insufficient data to track. Loans may increase in size as micro-enterprises grow since most MFIs don’t like to graduate their best clients. Also, savings deposit clientele of NGOs transformed to banks may not be the same as borrowers.

4.2. Strengths and Weaknesses of the Model

This model has many characteristics similar to the IPC/IMI Equity Investments in Microfinance Banks, in that the approach relies on a proven methodology with efficient start-up and rapid movement towards operational and financial sustainability. However, target clients are somewhat poorer and loans are smaller than for clients of IPC MFIs.[29] This probably results in higher costs and delays profitability. However, in countries where regulations permit NGO lending programs, start-up can be faster because the time required to obtain a bank license can be eliminated. Also, in IPC microfinance banks, equity investments must be obtained and start-up capital is more than in a grant-financed NGO MFI. However, NGOs may even begin start-ups as regulated banks (as OI did in Novi Sad) and then the models may merge.

[28] Micro Credit Montenegro was transformed to Opportunity Bank Montenegro in July 2002, OI Serbia was a new country start-up as a regulated bank and Moznosti in Macedonia is scheduled to become a bank during 2003. FINCA plans to transform its affiliate in Kyrgyzstan by 2005).

[29] FINCA targets the poorest sectors of the population and is committed to its methodology of non-collateralized loans even after transformations.

V. Credit Unions

A defining characteristic of this model is its focus on savings mobilization as well as lending. Credit unions serve diversified memberships, which leads to the development of a variety of savings and loan products to meet their needs. Members can grow their assets both through loans and savings. Credit helps entrepreneurs to access funds to supply working capital and expand businesses, and savings also contribute to asset growth by encouraging members to increase personal wealth in interest paying deposit accounts. Since members are diverse, a mixed outreach approach is required with micro loans as well as some small and medium loans of varying terms adjusted to the purpose of the loan. Using savings deposits to fund the loan portfolio reduces the average cost of capital and allows funds to be lent out at lower interest rates that those charged by NGO lending programs. An approach to strengthening these organizations has been to introduce a commercially oriented operating methodology[30] to achieve objectives of profitability, efficiency and market orientation and growth.

5.1. Discussion of Program Characteristics

5.1.1. Role of Technical Assistance

Technical assistance is the process by which credit unions are strengthened and commercialized. It consists of bringing in experts who can help credit unions, many of which were former cooperatives under state run economies, become efficient financial institutions. Model credit union building includes developing accounting and reporting transparency, financial restructuring and discipline to reduce costs, maintain a prudent loan portfolio and improve efficiency, identifying new products and clients, and even enhancing the image and marketing of the institution. It may also be focused on a regulatory and legal framework in the country to increase and protect members' savings (i.e. positive interest rates). Often a number of credit unions receive TA under the same program. In Macedonia WOCCU[31] established a Savings House with branches, while in Bulgaria and Romania, 13 and 26 credit unions, respectively, were strengthened.[32]

5.1.2. Staffing Configurations

Credit unions employ loan officers who use traditional micro-credit methodology to assess loan applications. The number of loan officers depends on the number of members, the setting (urban or rural) and dispersion of the members.

5.1.3. Policies on Equity Positions

IFIs tend not to take equity positions in credit unions, which are local institutions designed to serve their members.

5.1.4. Capitalization Policy

[30] Described by David C. Richardson and Barry L. Lennon in "Teaching Old Dogs New Tricks: The Commercialization of Credit Unions" October 2001 as Microenterprise Best Practices distributed by Development Alternatives Inc.

[31] World Council of Credit Unions has been a leader in developing credit union best practices and credit union commercialization methodology.

Savings deposits and institutional equity are generally used to finance loan portfolios. Savings are voluntary. Shares are purchased initially by members joining credit unions.

5.1.5. Business Development Services

Credit unions do not offer fee-based business development services (BDS). Loan officers may offer informal advice or refer members to other organizations offering BDS.

5.1.6. Level of Grant Funding

Grants are used to cover the costs of technical assistance to strengthen and commercialize credit unions. In Eastern Europe (Bulgaria, Romania, Macedonia) costs of these programs have ranged from $2 to $4 million.[33]

5.1.7. Policy on Cost Recovery and Financial Sustainability

Credit unions using commercialized methodologies are designed to cover operating costs from income generated on loan portfolios. Financial sustainability is determined by the spread between what is paid on savings deposits (the cost of funds) and what is charged for loans. After covering operational costs, income surplus is reinvested in the loan portfolio. An objective is to find equilibrium between borrowers, savers and real institutional growth.

5.18. Subsidy Policies

TA is subsidized while credit unions are strengthened and upgraded. Commercialized methodologies aims at paying depositors real interest (to cover inflation) covered by charges to borrowers.

5.1.9. Profitability as Measured by Return on Assets and Return on Investment

Credit unions look at returns on assets, growth of equity, and delinquency as measures of profitability and quality of portfolio. In 2002 ROA s of credit unions strengthened by WOCUU in three countries were positive. In Bulgaria[34] the ROA of 6.6% as of 9/30/02 was up from .8% on 12/31/99 for an annualized increase of 115% a year. In Romania[35] ROA increased over four years from 2.9% to 6%, an annualized increase of 19.9% and in Macedonia[36] from a –14.9% to 5.4%, an annualized increase of 9.68%.

5.1.10. Exit Strategies

Once credit unions have been strengthened with commercial methodologies and donor programs funding the provision of technical assistance have ended (typically 3 to 7 years), credit unions are expected to be sustainable with sufficient income to cover operational and financial costs and produce a surplus for equity investment.

5.1.11. Other Program Characteristics

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[33] In Macedonia $4 million was the cost of a 7-year USAID project carried –out by WOCCU to set up user-owned savings institutions to help revive the rural economy.

[34] Bulgaria – average for 13 credit unions

[35] Romania – average for 26 credit unions

[36] Macedonia – average for 5 credit union branches

Outreach as measured by number of members in the Bulgaria and Romania, the two countries with the most developed networks of credit unions, averages 3,260 per institution and this is comparable to that in MFBs or NGOs[37]. The average loan size, which ranges from $244 to $714, is more akin to that using group or village lending methodologies. However, since commercial credit unions can offer a variety of loan products, including microenterprise, housing, agriculture, education, consumer, etc., there is no reason why some loans cannot be upscaled. Savings deposits are critical to this model and credit unions are recognized for their ability to mobilize mass numbers of small voluntary savings accounts. Savings account outstanding balances range from about 68% of outstanding loan portfolios in Bulgaria to 43% of outstanding loan portfolios in Macedonia (Table 15). Savings are both voluntary and obligatory when members purchase shares as a requirement for opening up accounts. The ratio of obligatory share and voluntary savings to total savings in the three countries studied is about 40% and 60% respectively.

5.2 Strengths and Weaknesses of the Model

The strength of this model rests in its ability to mobilize savings and use them to capitalize portfolios to provide loans to members. Savings deposits provide low cost funds for loan portfolios. Membership in credit unions can be diverse, drawn either from communities or from places of employment. This diversity increases the demand for loan products and reduces risk since loan products are for diverse sectors and purposes. When credit unions follow best practices and commercial methodologies, they can be as efficient as NGO lenders or MFBs. They are restricted by the availability of liquidity, which is limited by the resources of members who save and accordingly, average loan size is relatively small. Also there are often regulatory restrictions that compromise protection of savings, for example, the inability of credit unions in Macedonia to collect deposits in foreign currency when annualized inflation in local currency is running at 6-7%. Credit Unions, which have not adopted commercial methodology may be inefficient, have inappropriate interest rate policies and offer insufficient products to too few members. These practices can cause both loan portfolios and savings deposits to de-capitalize.

[37] See Tables 5, 13, 14, 17

VI. Leasing

Financial leasing[38] is a system under which a leasing company (lessor) acquires equipment for a client (lessee) a supplies this equipment in return for payment for temporary possession and use. Russian legislation stipulates that this equipment can only be used for entrepreneurial purposes. In Russia the client or lessee makes the choice of the equipment source, although sometimes the rental agreement may state that the choice of the seller and the equipment supplied is made by the lessor.[39] Repayment terms are from 3 to 5 years at rates comparable to those charged for bank loans and in about 97% of agreements provide for purchase of the asset or equipment by the lessee, once the agreement concludes. Financial leasing is an appropriate financing system when there is a mismatch between terms of capital available through loans and the needs of the borrower.[40] Approximately 78% of operating leasing companies in Russia work with SMEs[41] and this can be an effective financing scheme as long as the enterprise is formal and pays taxes because leasing costs can be written-off on taxes as an expense. The most common kind of equipment leased is transport – trucks and passenger vehicles. The size of the market is measured by the value of equipment financed and in Russia from 1999 to 2002 this volume increased by nearly 500% form $.4 billion to $2.3 billion while the number of companies nearly doubled (see Tables 18-19). In part, this was due to efforts by the IFC's Leasing Development Group (LDG), which with financial support from the Canadian International Development Agency (CIDA) provided intensive TA in Russia to draft legislation and educate the public on the benefits of leasing. The LDG/TA model has since been used in Central Asia and a new program in the Caucasus is being set-up.[42]

6.1. Discussion of Program Characteristics

6.1.1. Role of Technical Assistance

Technical assistance is a key element of a strategy to encourage leasing. It consists of drafting and amending legislation to create a major playing field, and training the public, including potential entrepreneur clients on the advantages of leasing and banks on how to lend to leasing companies. The LDG staffing in Russia to disseminate TA included a lawyer, an economist, an accountant, project manager, public education specialist and team assistant. The TA model developed for Russia has been easily adapted for Central Asia where it was carried out much more rapidly. Donors other than the IFC pay for TA (except for administration costs). In Russia CIDA and DFID were financial partners and in Central Asia TA was funded by the Swiss.

6.1.2. Staffing Configurations

The LDG reports that the average Russian leasing companies consists of 8 employees including 2 managers, 2 accounting specialists, and one each in finance and marketing.

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[38] In Russia this is called a financial rental agreement
[39] IFC, LDG. "Financial Leasing in Russia; Market Survey 2001-2002.
[40] In Russia, for example, loans of more than 12 months are rare
[41] out of 117 surveyed leasing companies 78% reported working with SMEs IFC/LDG p.34
[42] The LDG is recognized internationally as the leader TA provider on a national level for new leasing programs.

6.1.3. Policies on Equity Positions

When the IFC invests in leasing companies, it takes an ownership stake of no more than 25% and as a passive investor, it does not act like a manager. When the investment is a joint venture, the IFC may initiate market analysis, a concept paper and feasibility study and help identify joint partners and start-up funds. The IFC seeks foreign private sector partners who have direct experience in leasing and sufficient equity. The partner is responsible for operations and sound financial management of the company. The IFC usually invests in the initial equity of the company and then provides a loan as long as the other founders of the company also provide loans.

6.1.4. Capitalization Policy

Most of the capital for leasing companies in Russia comes from banks, from those that set up leasing companies and from third party banks not associated with the leasing companies and from foreign banks.[43] Most use financing from several sources including banks, commercial credits from suppliers, issues of securities, etc. When the IFC extends a loan it is usually for 5 years, amortizing with a 1 or 2 year grace period on the principal. Interest rates are based on a margin over LIBOR based on credit risk and country conditions.

6.1.5. Business Development Services

Leasing companies do not offer BDS.

6.1.6. Level of Grant Funding

Leasing companies do not use grant funding. Grant funding is used to support TA preceding the set-up of a viable leasing sector in a country.

6.1.7. Policy on Cost Recovery and Financial Sustainability

Leasing companies typically recover costs of the equipment leased in 3 to 5 years. Their interest is to have successful clients so they usually extend a three-month grace period during which only interest is due.

6.1.8. Subsidy Policies

TA to develop the leasing sector is grant-funded and accordingly, subsidized. Loans by investment donors such as the IFC or EBRD frequently have a grace period during which only interest is repaid. Leasing companies will sometimes extend a short grace period to their clients.

6.1.9. Profitability as Measured by Return on Assets and Return on Investment

Interest rates charged to clients on leasing are comparable to what they would pay to banks after tax benefits are considered. Leasing companies earn the difference between the spread that they pay for financing and what they charge clients (see Table 20).

6.1.10. Exit Strategies

[43] In the LDG survey of 114 companies, 71% said they had received financing from third party banks, 29% from founder banks, 13% from foreign banks and 32% from suppliers.

Private companies take the lead in the leasing market. When the IFIs such as the IFC take an equity position, they sell their shares to partners who own the companies. When a multilateral bank extends a line of credit, the loan terms become the exit strategy. TA programs are set up with objectives and timeframes to complete the program.

6.1.11. Other Characteristics

The outreach of leasing companies is defined in terms of the numbers of deals and portfolios, which are defined as the total amount of payments to be received. Averages may be skewed by a few large companies and accordingly, medians may be more indicative of outreach (see Table 19). The number of deals in Russia increased by 26% from 2000 to 2001 while the median volume size of deals in dollars only increased by 9.4%, an indication smaller companies are being financed.

6.2. Strengths and Weaknesses of the Model

This model is especially appropriate for formal-sector SMEs, which pay taxes and do not have access to long or medium-term financing. The interest rates paid by lessees are comparable to bank loans when they can write-off costs for tax purposes. Otherwise, it is not a sound financing alternative. The main obstacles facing leasing companies are insufficient financing and equity and a lack of trained personnel with expertise in the field. In Russia, production equipment follows transport equipment as the most popular equipment leased, indicating that leasing is a viable source of financing for production enterprises and the size of median deals in 2001, $58,000, and median range, $7,000 to $308,000, indicates that leasing is a viable source of financing for SMEs.[44]

[44] LDG Survey, page 42

VII. Direct Equity Investments in SMEs

This model consists of supporting SMEs directly with equity investments channeled through funds, which invest in small enterprises with high growth potential. Investments may include a debt as well as an equity component.[45] Funds are generally financed by shareholders who take out equity positions which they agree to hold over the life of the fund, normally 10 years. A leader in administration of such programs is Small Enterprise Assistance Funds (SEAF), formerly CARESBAC[46] facilitates SME investments through local investment for-profit funds. The EBRD also has a Direct Investment Facility that does direct equity investments through funds or on its own. This model has a number of unique characteristics. Most returns are not realized until exit, when the fund sells its shares in an investee company. Accordingly, the relationship between the fund and the investee is a partnership in which both work together to strengthen the company with a hands-on approach that relies heavily on appropriate BDS. The objective of this approach is to grow a company's income and assure a maximum return over the life of the investment, typically 4 to 7 years.[47] Investments in SMEs[48] by SEAF funds tend to be small averaging about $212, 000 in equity and $164,000 in debt,[49] whereas EBRD investments are typically $1.5-$1.75[50] million. Successful investee companies which grow from small to medium have an economic impact beyond the returns of the investment because they productively employ a fair number of people, pay taxes which supports the community and serve as models for other companies in their sector.

7.1. Discussion of Program Characteristics

7.1.1. Role of Technical Assistance

Technical assistance is provided to train fund personnel. The amount and the nature depend of the previous experience of staff personnel, and especially of the fund manager. An inexperienced staff must be taught 1) good management techniques 2) how to identify recipient companies for equity investments, 3) to promote the culture of equity investments, 4) to provide hands-on assistance, advice and identify outside sources for appropriate BDS for recipient companies, and 5) to help recipient companies identify needs and sources of debt financing. In addition, before funds can function, the legal and regulatory procedures must be in place so that appropriate investment agreements can be drawn up.[51] Funding for TA and start-up costs comes from grants to SEAF (about 25% of USAID grants go for TA in the field and the rest for on-lending) and from management fees charged to equity shareholders.[52] The EBRD depends on donor funding to cover TA costs, which average about $75,000 per project.

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[45] In investments managed by SEAF typical ratio is 30% debt and 70% equity

[46] CARE Small Business Assistance Corporation

[47] Investment periods range from1 to 9 years with the median falling between 4 and 5 years, for SEAF investments with exits, both successful and liquidations.

[48] Defined as companies with 10 to 150 employees and annual revenues of not more than $3 million

[49] SEAF Portfolio Company Details as of December 31, 2002

[50] One was $375,000 and investments in Central Asia tend to be below $1 million

[51] These tasks are usually handled by local law offices, but may occasionally be handled by international firms.

[52] Generally about 3% of their equity investments into a fund

7.1.2. Staffing Configurations

A SEAF start-up office consists of an average of seven or eight employees, including the fund manager, four to five investment officers who have financial analysis capabilities, an accountant who can audit the investee companies and possibly an office manager. Having an experienced fund manager is critical because appropriate selection of recipient companies can increase returns and decrease investment period until exit. After the investment period of about three to four years, staff is usually downsized and by the end of the fourth year investment stops and preparation for exit (the harvest period) begins.

7.1.3. Policies on Equity Positions

Shareholders are IFIs, which take out equity positions with pure equity risk in the investment funds. Shareholders agree to leave their capital for the life of the fund, generally 10 years, although sometimes there are one or two year extensions. Some IFIs, such as the IFC, prefer not to take out positions of more than 25%; others such as the Swiss (SECO) will go up to 50%. The average share position of the funds in recipient investees is about 35%. Funds choose to be minority shareholders to facilitate exits.

7.1.4. Capitalization Policy

Investment funds are capitalized by equity shares of investing IFIs. In addition, fund staff often help the recipient company obtain debt financing from banks and this keeps helps to maintain financial balance. Increased profits are re-invested into the business to increase equity capital, except for that which is paid out in dividends to shareholders.

7.1.5. Business Development Services

Business Development Services (BDS) to investee companies are critical to stimulating growth and sales. BDS is provided both by fund investment officers and by outside consultants accessed by fund staffs. Local investment-officers help arrange financing. Expat consultants are brought in to strengthen planning, production, financial controls accounting, marketing, and supplier and distribution networks. Consultants are drawn mainly from voluntary organizations whenever possible such as ACDI/VOCA, the IESC, Citizens Development Corps (CDC), and similar organizations from Britain, France, the Netherlands, Germany and Canada.[53] The BDS recipient usually pays for transportation and hotel of the consultants and SEAF provides translators and follow-up. BDS is paid for in part by a 3% fee charged up front to the investee on the overall value of the equity investment.[54] The EBRD depends of multilateral (e.g. EU) or bilateral country specific donors to cover costs of TA and BDS.

7.1.6. Level of Grant Funding

Grant funding is used to cover the cost of TA to the investment fund and part of the TA costs to companies. A total of $41.5 million has been invested in SEAF equity investments and $11 million has been received in grants used for TA in the field, home

[54] What is not covered by fees is usually covered by grants

office support,[55] and special studies. The EBRD covers external transaction costs (including BDS to companies) with donor grants and absorbs internal transaction costs, but considers both when calculating IRR.

7.1.7. Policy on Cost Recovery and Financial Sustainability

The objective is to recover equity investments and profits, which are distributed to investment fund shareholders. SEAF is moving towards sustainability that will cover a larger proportion of costs of operation and BDS expenses that have that have previously been covered with grant funding. For example, investment funds now charge management fees to IFI investor partners and consulting fees to recipient investee companies.[56] In addition 3.3% may be deducted from current income generated by a fund's investments. Top management estimates that it costs 3.5% to operate a $10 million fund. Ideally, fund size should be about $15 million to reach economies of scale, which would lower costs. Fees are charged to cover more BDS expenses. Experience with funds is expected to result in better selection of companies, more efficient operations, faster exits and lower costs because lessons learned can be applied.

7.1.8. Subsidy Policies

Equity funds are expected to generate positive rates of return on investments reflecting the growth of an SME partner. Nevertheless, grant funding has supported operating costs (especially start-up), special studies and global support efforts, such as providing export marketing assistance for portfolio companies.

7.1.9. Profitability as Measured by Return on Assets and Return on Investment

Profitability from equity investments is generated when the investors exit at the end of the investment period and sell their shares and during the period when dividends are declared by the company and issued to the shareholders. SEAF investment funds have had 96 exits[57], of which 53 were successful (55%) and 43 were write-offs or liquidations. The gross IRR on the 96 investments with exits was 8% and the multiple of invested capital consisting of realized proceeds and residual value at exit was 1.274. (See Table 22.) If one assumes that an average fund is $10 million and that the percentage return needed for operations is 3.5%, then the return to equity shareholders is 4.5% annually.[58] However, these returns do not incorporate grants used for TA.[59] The EBRD equity operation has had no exits so profitability cannot be determined yet.

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[55] Of $27 million received by SEAF in USAID grants, $20 million was used to capitalize the investment fund and all but 1.6% of $7 million was used for TA and field operating expenses. Of $4 million in grants from other sources, $1.3 million was used to support SEAF headquarters and this includes $1 million from the IFC used to develop a worldwide accessible data bank with a central server. Other grant sources are DFID, SECO, SENTER, Eurasia Foundation, Ford Foundation. Total grants for TA include $1.1 million for Central Asia, a new program, where there have been no exits.

[56] Management fees vary, but average about 3%, whereas consulting fees range from 2-3% of equity investment received.

[57] As of December 31, 2002 out of a total of 203 investments

[58] dollar based

[59] To calculate return on investment with grants, one would divide profit by the sum of total grants used to support those funds plus total fund investment equity capital. Grants are equal to about 27% of total invested capital in SEAF programs in Eastern Europe

7.1.10 Exit Strategies

The exit strategy of shareholders is to sell their shares to other owners/managers of the firm or to outside buyers. However, SEAF tries to provide for flexible exits and therefore does not insist on the signing of "puts"[60] with agreements. SEAF prefers "calls" which state that if the investee does not purchase shares at a given price, usually 40-60% of IRR on the dollar denominated investment, the fund has the right to sell its shares to a third party. SEAF has found that "puts" are not efficient because often the owner's expectations as to what the fund will accept, are too low. Also by specifying a price ahead of time, the owner knows if firm performance is higher than that specified, he/she will reap the additional. SEAF also employs a "tag along, drag along" strategy. If an entrepreneur identifies a strategic partner and sells a portion or all of his shares, the fund will sell its shares ("tag along"). If, on the other hand, the fund (or SEAF) finds an outside shareholder to buy the company, SEAF may encourage the owners to support the sale ("drag along"). The EBRD Direct Investment Facility has made 27 equity investments with no exits yet.

7.1.11. Other Characteristics

Outreach as measured by the number of companies receiving equity investments is much lower than for models, which provide merely debt financing or leasing services. A total of 203 investments had been made into companies by SEAF from 1992 through the end of 2002[61] and successes have accounted for on the order of 55-57% of the total number of investments exited. Nevertheless, the impacts of these companies are significant because they often hold an integral place in supply chains, offer customers a variety of new products that would not otherwise be available, pay taxes that develop communities and infrastructure and provide growing employment.

7.2. Strengths and Weaknesses of the Model

This model builds and develops formal sector companies that may upscale from small to strategic medium-sized enterprises. It is premised on a mutual partnership between the investee and the investor as both collaborate to strengthen the firm and increase and profits. To achieve sustainable growth intensive hands-on BDS is provided in all aspects of the business both by investment fund analysts and outside consultants. Shareholders provide equity capital to investment funds on a for-profit basis and overall the return on invested equity capital in SMEs has been positive.[62] The most common criticism directed towards this model is that it does not impact a sufficient number of firms because mentoring companies is such a hands-on intensive process. A better measure of impact than number of companies receiving investments might be to study the larger economic impact of successful investee firms.[63] If investment funds can achieve economies of scale, if initial start-up costs are reduced, and if innovative ways are identified to finance BDS, returns should increase even if grant funding is costed-out of the gross IRR.

[60] obligation of the investee to purchase the investors' shares
[61] 175 of these were in Eastern Europe
[62] 1.274% multiple of invested capital as of 12/31/02 without factoring in grants
[63] SEAF and DFID are about to undertake such a study

VIII. Conclusions

Each of the models discussed in this report has strengths, which depend on specific target clients in the MSME sector and country conditions. For example, credit unions and NGOs are more appropriate for micro or small clients, either formal or informal. Credit unions have the advantage of mobilizing savings, which capitalize loan portfolios. Best-practice NGOs use methodologies designed to efficiently reach target clients, usually very small entrepreneurs. IPC/IMI micro-finance banks also follow a tested methodology and have demonstrated that they can be up and running and making loans in relatively short order. This is a relatively new model in Eastern Europe and requires investors with capital that they are willing to commit for relatively long periods. All of the programs reviewed under the commercial bank partnering model are using or have used lending funds supplied by donors, although theses funds have a cost. Clients of commercial banks include micro, small and medium, although definitions of micro and small loans vary significantly with many banks defining micro up to $15,000, while an NGO as FINCA or OI which target micro, have loan sizes much smaller. Leasing and direct equity investments are more appropriate to finance somewhat larger small businesses in the formal sector. Leasing is advantageous only to clients who pay taxes and can write off leasing expenses from their incomes. It is especially appropriate in countries without capital for medium or long-term loans. Companies identified for direct equity investments are small formal companies with potential to grow into medium-sized enterprises.

All of these models have significant TA components, which are usually grant funded. The IPC/IMI model theoretically identifies the proportion of TA as about 35% of the total investment, but this may vary depending on country. The NGO models have similar proportions of TA and the credit union model requires TA to introduce commercialization into existing or new credit unions so that they can be operationally efficient. Both the leasing and direct equity investment models require start-up TA, leasing to prepare the market for its introduction and direct equity investments to set up funds and perhaps cover initial transaction costs and at least some BDS provided to recipient companies.[64] In all models TA is financed by grants and institutions generally do not cost it out when reporting on their returns.

Profitability is tracked under the models using various indicators depending on the objectives of the program. IPC/IMI MFBs emphasize return on equity because an important objective is to attract equity investors by promising specific target returns. Six of nine MFBs in Eastern Europe report profits and the new MEB in Serbia reported a first-time profit in February 2003. This model is not designed to produce profitable institutions until the third year of operations. SEAF also emphasizes its return as a multiple of invested capital (distributed among equity shareholders in investment funds) and gross IRR on all investments (which does not cost out grants used to support

[64] To date in the SEAF program in Eastern Europe grants are equal to about 27% of equity invested in SMEs.

operating expenses and BDS). Credit unions, NGOs and commercial banks report return on assets, although commercial banks tend not to disaggregate returns by type of loan. Arrears are generally used to indicate quality of loan portfolios by all institutions. The model supporting commercial banks is premised on the assumption that once banks have entered the SME market, they will continue to serve the market because it is profitable.

Three out of the six models offer savings deposit accounts to clients and this reduces their cost of funds for loans. A principal reason that NGOs transform themselves into regulated financial institutions is so they can offer savings deposits. Sometimes country regulations are such that NGOs must start up as regulated financial institutions even to offer small loans. Accordingly, as transformations play out, this model may converge into that of the IPC/IM MFBs. As the variety of players increases in the market, this will foster competition and entrepreneurs will have more options for savings and borrowing.

All of these models demonstrate successful results. However, it is still too early to carry-out analyses to determine which models are most successful. Success, in part, depends on country environment, market conditions, maturity of institutions, implementing partners, and target clientele. It is important for donors to clearly identify their overall objectives and select models appropriate for their achievement. It is useful to have a common methodology for calculating return on investment that considers grant financing, as well as equity investments, because this facilitates comparisons between models and institutions.[65] However, to be comparable, institutions and programs should be at the same level of maturity and in similar country settings. Quantitative results may then be weighed against qualitative objectives to determine which models and programs are most appropriate.

[65] The tables presented in Annex B are a step in that direction

ANNEX A

COMPARISON MATRIX

COMPARISON OF MODELS MATRIX Part 1

Program Characteristics	Models					
	Equity Investments in Microfinance Banks IPC/IMI	**Partnering with Commercial Banks**	**NGOs (includes transformations)**	**Credit Unions**	**Leasing**	**Direct Equity Investments in SMEs**
Role of TA	TA is integral to equity model to set up highly efficient institutions. Financed by investor grants to MFBs; includes both ST and LT expat and local consultancies focused on credit expertise, accounting, control, portfolio monitoring, IT, training loan officers, branch managers. During 3 yr. Start-up provides salary support, acquisition of fixed assets and stipends.	TA (TC) used to support SME lending, usually from an existing dept. Includes training loan officers and branch managers in basic credit methods, i.e. cash flow analysis, monitoring, marketing, customer oriented credit techniques. Both LT and ST expat expertise may be provided and stipends for trainees and seminar costs covered. Sometimes all staff of partner banks, including top mgmt. is trained.	Initial TA covered by donor funding (usually grant); includes training of loan officers and management in methodologies of NGO. Initial staff may be NGO expats who train local staff or local staff may be trained on site at another of the NGO's institutions in another country. TA grant usually covers acquisition of fixed assets. Typically 30-35% of start-up grant used for TA/TC.	TA focuses on model credit union building and is often provided to groups of credit unions in a country. It includes accounting, reporting, cost reduction, marketing, identifying new products and clients.	IFC is the leading multilateral in providing TA to develop leasing on a national scale. leasing. It includes: public education; teaching banks, local governments, and companies how to form leasing companies; teaching advantages of leasing to SMEs; and drafting federal legislation.	SEAF offers TA to managers and staff of equity funds. Includes an MIS system where all investment data are available. This system helps new equity investors who want to focus on specific sector. Organize retreats to share knowledge. EBRD offers donor-funded TA to pay costs of about $75,000 per project of which legal work is most expensive.
Staffing for Loan Programs	Loan Officers use site visits and cash flow analysis to determine feasibility and parameters of loans. Avg. no. of clients per loan officer in 9 E.E. MFBs is 120	Staffing determined by bank and SME lending may be through credit departs., retail credit depts. & branches. In Kazakhstan average no. of clients per loan officer is 49.	Loan officers responsible for marketing program and handling loan applications, site visits and portfolio monitoring. Number of loans per officer depends on loan product & location. Usually 100-200 loans per officer	Loan officers handle loan applications, which are approved by credit committee. Avg. no. of clients to loan officers depends on setting and dispersion of members	Avg. leasing company in Russia has 8 employees in management, accounting, finance and marketing.	SEAF equity funds have well-trained staff to 7-8 professionals including fund manager, accountant who can audit, office manager, investment officers, to identify partner SMEs and provide informal advice and set-up BDS as needed.

BDS to Clients	No in-house BDS, although loan officers may make suggestions. Clients may be referred to other organizations.	No in-house BDS, although loan officers may make suggestions or referrals to other organizations.	Loan officers may offer suggestions and referrals to other organizations and may even sign agreements w/ organizations offering BDS.	CUs usually don't have in-house BDS. Loan officers may make suggestions and referrals to other organizations.	Leasing companies do not offer formal fee-based BDS to clients.	BDS to SMEs is critical; provided fund analysts and expats from voluntary organizations. BDS is comprehensive and designed for individual SMEs. Clients charged 3% of equity investment to cover some BDS costs.

COMPARISON OF MODELS MATRIX Part 2

Program Characteristics	***Models***					
	Equity Investments in Microfinance Banks IPC/IMI	**Partnering w/ Commercial Banks**	**NGOs (includes transformations)**	**Credit Unions**	**Leasing**	**Direct Equity Investments in SMEs**
Policies on Equity Positions by IFIs	IMI/IPC investors take long-term equity positions and maintain their position as the majority shareholder. IFI partners exit after demonstration phase and their shares are purchased by IMI and/or private investors. Some IFIs have shares both in IMI and in individual MFBs.	IFIs normally do not take equity positions in partner banks, but rather set up SME lending within banks.	IFIs generally don't invest in start-up NGO affiliates, although head NGO office may make equity investments. Parent NGOs take positions in transformed NGOs to control governance. Other IFIs may take equity stakes at that time.	Members own equity in their credit unions, commonly referred to as institutional capital.	IFIs (i.e. IFC) take positions with foreign partners who have equity and management experience.	Investment fund shareholders are IFIs, which take out equity positions over life of fund. Some shareholders (IFC) limits position to 25%; others go up to 50% Shareholders include USAID, EBRD, FMO DEG. Fund then takes out minority position in SME for 4-7 years (avg.) Fund shareholders receive returns on their investments.
Capitalization Policy	Initial capital provided by equity buy-ins. Subsequent loan capital also from depositors' savings and commercial lines of credit. Retained earnings reinvested to build institutional capital.	Funds for SME lending initially provided by partner banks donors such as the EBRD, IFC or other IFIs with cost of funds depending on country and bank and sometimes by the partner banks themselves. Over time partners expected to provide more of their own capital. Retained earnings	Start-up grants from donors typically used for initial capitalization. This may be augmented with commercial financing, including lines of credit from IFIs.	Initial capital usually from joining fee of members (must remain on deposit while they are members). Additional capital comes from savings deposits. Retained earnings are reinvested in the institution.	Capital comes from commercial banks, either associated with leasing company or outside Other sources of capital include credits from suppliers or IFIs. IFC may extend lines of credit for 5 years at rates based on credit risk and country	Investment funds capitalized by equity shares of investing IFIs. SMEs capitalized with equity investments and debt financing. Increased profits re-invested into SME to increase equity capital except for that paid out in dividends.

		reinvested.			conditions.	
Level of Grant Funding	.Approximately, one third of first time capital is in the form of grants used for TC to cover initial operating expenses, fixed assets and pay stipends/salaries.	TA (TC) is grant funded by donors such as KfW, EBRD, FMO, DOEN, USAID, & US/EBRD SME Facility. Level is variable, but normally TC grant funding lasts 12-24 months.	New country affiliates set up with grant funding. 30-35% of initial grant for start-up costs including expat salaries and the rest for loan portfolio.	Grants may be used to offset start-up costs, for institution building: i.e. to train personnel, acquire fixed assets and technical assistance to instill commercialization.	Donor grants fund TA to educate the public about the pros and cons of leasing and how to set up companies. No grant funding to companies.	Grant funding to cover some operational costs, initial TA and part of BDS is equal to about 27% of invested capital. EBRD uses donor grant funding to cover transaction costs of about $75,000 per project.

COMPARISON OF MODELS MATRIX Part 3

Program Characteristics	Models					
	Equity Investments in Microfinance Banks IPC/IMI	**Partnering w/ Commercial Banks**	**NGOs (includes transformations)**	**Credit Unions**	**Leasing**	**Direct Equity Investments in SMEs**
Policies on Cost Recovery and Financial Sustainability	Goal is to become profitable by year 3. 1st yr. 90% of operational costs funded by grants; 2nd yr. drops to 50%, 3rd yr. breakeven.	SME lending set up to be profitable, although the time to achieve this varies. In Kazakhstan partner banks cover 70%-90% of operational expenses after 4 years.	Policies vary. Best practices NGOs aim at operational sustainability in 2 yrs and financial sustainability in 4-6 yrs.	The goal is to promote savings and provide savers w/ real rates of return. Interest rates on loans cover operational costs and cost of capital from savings deposits.	Leasing terms are designed to recuperate investments in 3-5 yrs.	Equity funds expect to recoup cap. investments with profitable returns in 4-7 years. Grant funding covers a portion of operational, TA and BDS costs
Subsidy Policies	Loans are not subsidized, but TC and operational costs are subsidized for about 3 years. Loan portfolio created with long-term equity buy-ins, which keeps initial financial costs lower than commercial rates.	Loans to end-users are not subsidized, but technical assistance to train staff are subsidized. EBRD has a decreasing subsidy (performance fee) to commercial banks that do SME lending in E.U. accession countries. This incentive lasts for 3 years and is phased out over the next two. Purpose is to draw banks into SME market.	In established best practice NGOs, loans to end-users are not established. However, during start-up until a critical mass is reached, income from loans may not pay all costs (e.g. expat salaries)	In best practice CUs (i.e. those sponsored by WOCUU) loans have market rates of return with real rates of interest.	TA to set up leasing programs is subsidized with grants from donors. Leasing companies in Russia program typically granted clients a 3 month grace period during which they only paid interest.	Invested equity capital generates positive rates of return. Costs of TA, operations, special studies, BDS partially subsidized. EBRD subsidizes transaction and BDS costs.

Profitability as Measured by ROA and ROI	Range ROE in a sample of 8 MFBs is from (19%) (MFB Serbia) to +49.9% at MEB/Kosovo. Avg. ROE for E&E is 7.4% & median is 3.2%. Return on total investment (including TC ranges from (13.6%) to 35.2% with median of 6.1%	Profitability is not usually allocated by dept. or type of loan and accordingly, profitability of SME lending is not tracked. In 3 cases where it could be tracked, ROA or return on portfolio ranged from 4.5-6.1%.	Range of ROAs for 15 best practice NGOs in 15 countries was (19%) to 24% with a median of 1.7%.	Net Income/Average Assets: 5.4%-6.6%	Interest rates charged to lesses comparable to those charged by banks (after tax considerations) Leasing companies earn difference between spread they pay for funds and what they charge clients	Gross IRR for 96 SEAF exits (including both successes and liquidations) is 8%, and multiple of invested capital is 1.3. Cost of operating a $10 m fund is 3.5%, giving investors an annualized return of 4.5%.

COMPARISON OF MODELS MATRIX Part 4

Program Characteristics	Models					
	Equity Investments in Micro Finance Banks IPC/IMI	**Partnering with Commercial Banks**	**NGOs (includes transformations)**	**Credit Unions**	**Leasing**	**Direct Equity Investments in SMEs**

Outreach	Number of clients estimated by number of loans outstanding, ranges from 1,186 in Moldova to 29,628 in Georgia, with a median of 5,615	Number of clients estimated by number of loans disbursed, ranges from 44,365 in Kazakhstan to 47 in a Shorebank partnership with 3 commercial banks in Armenia. The median is 383	Number of clients as measured by number of loans in outstanding portfolio ranges from 598 to 19,789 with a median of 2,282	Number of members in credit unions in 3 countries are 12,118 in Bulgaria, 115,004 in Romania and 1,909 in Macedonia (fewer credit unions assisted and tracked)	52,250 in Russia estimated by multiplying the median no. of deals by the no. of actual companies	175 total investments in Eastern Europe; 27 in current EBRD Direct Investment Facility
Savings	Range from € 1 M in Romania to € 264.3 M in Kosovo with a median of € 12.9 M.	Not available as savings is not tracked by type of customer.	NGOs are not allowed to mediate savings.	Voluntary customer savings in US$ total .3 M in Macedonia, 1.5 M. in Bulgaria and 9.6 M in Romania.	Not available or applicable.	Not available or applicable.
Exit Strategies	IMI holds majority shares over long-term to assure governance. Other shareholders exit in medium-term by selling shares to IMI, other partners or floating them on the stock market. TC phased out after 2 years.	Programs set up for specific time frames and exit occurs when TA is completed. Exit strategies vary. EBRD Accession uses its phased out fee approach as exit strategy along with 2 yr. TC program. SAS sold its portfolio in Georgia to partner bank. If an IFI sets up a line of credit, the loan terms become its exit strategy. USAID exit from ABK was to sell it to a foreign bank.	Strategies are different depending on NGO. Home office TA usually ends after 2-3 years and then affiliate functions as a local organization according to its charter. Some affiliates may transform into banks and primary NGO retains equity shares to assure governance.	Credit unions are on-going financial institutions and once they are up and running smoothly, the organization providing TA can withdraw.	Once TA has been completed and leasing companies established, the TA provider (i.e. IFC) closes its office and exits. When IFIs take equity positions in leasing companies, their exit is to sell their shares to partners who own the company. If a line of credit is extended to a company, the loan terms become the exit strategy.	After 4-7 years, the equity fund sells its share in the SME either to the owners or to a third party. "Calls" are more common that "puts" for SEAF whereas the EBRD and IFC prefer "puts" where owners agree to buy shares.

ANNEX B

TABLES

TABLE 1
IPC Micro Finance Banks
Total Assets, Equity, Outstanding Portfolios, Customer Savings, TC
12/31/02 EUROS (millions)

Year Est.	Location	Total Assets	Equity	Outstanding Loan Portfolio	Customer Savings Deposits	TC[66]	TC disbursed in 2002[67] €	Total Investment Equity+TC	Post Tax Profit
'98	Russia[68]	N/A	11.4[69]	N/A	N/A	1.5[70]	1.5	12.9	1.5[71]
'99	Kosovo	288.6	9.8	23.6	264.3	4.1	0	13.9	4.9
'99	Albania	72.5	7.7	28.7	53.7	2.1	.58	9.9	1.0
'97	Bosnia	41.1	7.3	32.1	9.9	2.9	.31	10.2	0. 7
'99	Georgia	43.6	5.6	33.0	9.5	3.2	.43	8.8	0.5
'00	Moldova	4.9	0.7	4.0			.35	0.7	.002
'01	Bulgaria	38.2	5.7	27.7	12.9	1.4	.67	7.15	0.2
'01	Ukraine	30.1	9.6	25.0	3.7	12.3	1.3	21.9	(0.5)
'01	Serbia	67.7	7.3	38.2	42.5	2.9	1.7	10.2	(1.4)
'01	Romania	16.0	9.2	10.1	1.0	0.9	N/A	10.1	(0.7)

TABLE 2
IPC Micro Finance Banks
Performance Ratios

	Equity/Assets %	Portfolio/Assets %	ROE %	ROA %	TC/Tot. Investment %	ROI %
Russia[72]	N/A	N/A	13.1[73]		11.6[74]	11.6
Kosovo	3.4	8.2	50	1.7	29.5	35.2
Albania	10.6	39.6	12.9	1.4	21.2	10.1
Bosnia	17.8	78.1	9.6	1.7	28.4	6.9
Georgia	12.8	75.7	8.9	1.1	36.4	5.7
Maldova	14.3	81.6	.2	.04		
Bulgaria	14.9	72.5	3.5	.5	19.6	2.8
Ukraine	31.9	83.0	(5.2)	(1.7)	56.2	(2.3)
Serbia	10.8	56.4	(19.2)	(2.1)	28.4	(13.9)
Romania	57.5	63.1	(7.6)	(4.4)	8.9	(6.9)

66 Reported in the Semi-Annual Report of the US/EBRD Financing Facility Technical Cooperation Projects, September 30, 2002. Includes cumulative US dollar disbursements from the Facility and total co-financing programmed by other partners.
67 Information supplied by EBRD. Not specified if this is only from the US/EBRD SME Facility or includes funds from co-financing partners
68 KMB Russia – although not an IPC/IMI microfinance bank, this bank geared towards small clients is tracked by the EBRD with those banks
69 December 2001
70 Only for 2002
71 Based on post-tax profit January – August 2002 annualized
72 KMB Bank performance ratios provided by Elizabeth Wallace of the EBRD
73 Based on post-tax profits January-August 2002, annualized and equity as of December 2001
74 Only includes TC disbursed in 2002

TABLE 3
IPC Micro Finance Banks and Russian Small Business Investment Fund
Profitability Indicators
US$[75] (2002 year-end reports)

Institution By Location	Average Assets	Avg. Outstg Loan Port.	Net Int. & Fee Inc. from Port	Net Profit	Int.+Fee Inc./Avg. Port %	Net Profit/Avg. Port. %	Net Profit/Avg. Assets %	Arrears > 30 days %
Russia[76]	61.0[77]	27	1.91	3.3	7.1	12.2	5.4	N/A
Kosovo	328.5	15.74	1.85[78]	5.90	11.8	37.5	1.5	.5
Albania	69.6	22.65	2.62[79]	1.08	11.6	4.8	1.5	2.1
Bosnia	42.2[80]	32.39	5.44[81]	.70	16.8	2.2	1.6	.6
Georgia	39.3	32.19	6.98[82]	.49	21.6	1.5	1.2	3.4
Bulgaria	46.9	31.34	5.17[83]	.19	16.5	.6	.4	.06
Ukraine	25.6	31.38	3.72[84]	(.48)	11.8	(1.5)	(1.9)	.5
Serbia	59.4[85]	23.5[86]	7.40[87]	(1.46)	19.4	(4.2)	(2.4)	.4
Romania	12.9[88]	10.82	2.08[89]	(.75)	19.2	(6.9)	(5.8)	.5

75 Unless otherwise indicated
76 Russian Small Business Investment Fund
77 in Euros, based on 2000 and 2001 financial statements
78 total interest on loans + fees – interest expense from 2002 financial statements
79 total interest from lending + commission on banking income – interest expense
80 Based on assets as of 12/31/02; average for year not available
81 net financial margin annualized
82 net interest + fee income for 2/03 annualized
83 net interest income + net fee income for 2002
84 net interest income + net fee income annualized
85 Euros
86 Euros
87 net interest income + net fees annualized
88 Based on average from 5/02-12/02
89 net financial margin

TABLE 4
IPC Micro Finance Banks
Distribution of Loans by Size
(using outstanding portfolio 9/30/02)

Bank by Location	< $10,000		$10,001-$50,000		Over $50,000	
	% amount of port.	% no. of loans	% amount of port.	% no. of loans	% amount of port.	% no. of loans
Kosovo	49	83	40	15	10	1
Albania	41	88	39	10	20	1
Bosnia	44	85	28	13	28	2
Georgia	41	93	36	6	23	1
Bulgaria	26	83	42	15	32	2
Ukraine	39	88	36	10	25	2
Moldova	N/A	N/A	N/A	N/A	N/A	N/A
Romania	47	85	50	15	3	.2
Serbia	27	72	53	26	20	2

TABLE 5
IPC Micro Finance Banks
Number of Outstanding Loans and Average Loan Size

Bank by Location	Number of Loans Outstanding 1/31/03	Average Outstanding Loan Size Euros
Kosovo	4,928	4,798
Albania	5,615	5,162
Bosnia	7,170	4,461
Georgia	29,628	1,051
Moldova	1,186	3,295
Bulgaria	5,453	5,269
Ukraine	6,377	3,749
Serbia	11,052	3,555
Romania	2,718	3,716

TABLE 6
Micro Banking Bulletin
Benchmarks by Profit Status for 147 MFIs Worldwide[90]

MFI Classification	Yrs. Functioning as MFI	Adj. net income after taxes/avg. assets %	Net income/equity %	Yield on gross portfolio %	Yield on gross portfolio adj. for inflation	Outstanding balance of loans overdue> 30 days/gross loan portfolio %
All MFIs	8	(2.7)	(6.1)	36.6	27.8	12.1
Financially self-sufficient MFIs	12	5.5	14.1	40.6	32.3	3.7
Financially self-sufficient non profit MFIs	13	5.9	11.3	41.4	33	3.0
Financially self-sufficient for profit MFIs	10	3.9	20.5	38.5	30.4	4.9

90 As reported in Micro Banking Bulletin Issue #8 October 2002
www.mixmbb.org

TABLE 7
Commercial Banks
Total Assets, Outstanding Portfolio, SME Portfolio, Net Income
Year 2002 US$ (millions)

Bank	Total Assets	Total Portfolio	Portfolio/Total Assets %	SME Portfolio	SME Port/Total Portfolio %	Equity	Net Income
Georgia 1 [91]	102.3	50.0	49	33.2[92]	66	14.3	4.8
Romania[93]	296.4	170.0	57	130.0	76	N/A	N/A
Georgia 2[94]	15.68[95]	6.2[96]		4.3[97]	54	5.63[98]	.051[99]
Georgia 3[100]		32.1	N/A	27.6[101]	73		.6
Shorebank U.S.[102]	1,173.0	204.9	17	204.9	100	80.2	13.5

TABLE 8
Commercial Banks
Performance Ratios

Bank	Equity/Assets %	ROE %	ROA %	Net Profit/ Portfolio %	Arrears> 30 days %
Georgia 1	14	4	6.1	9.6	1
Romania	N/A	29	5.3	N/A	0
Georgia 2	33[103]	11[104]	4.0	8.9[105]	N/A
Georgia 3	N/A	N/A	N/A	3.1[106]	N/A
Shorebank US	7	17	1.2	6.6	3

[91] Tibilisi Business Center Bank (TBC) Shorebank partner in Georgia
[92] includes DEL loans from US$ 1,000- US$10,000 and SME loans over $10,000
[93] Shorebank partner Romania
[94] Tbiluniversal
[95] average assets in lari from 2001 financial statement
[96] As of 2/28/03 in U.S. $
[97] Includes micro loans up to $15,000
[98] In Lari; taken from 2001 financial statement
[99] Estimated from interest rate charged minus estimated allocated costs
[100] Bank of Georgia from report submitted by credit department by Temur Abuladze, Deputy Director
[101] Includes$.2 million of micro loans up to $15,000, $5.5 million of small loans ($15,000-$100,000) and $17.9 million of medium loans ($100,000-$500,000)
[102] used as a US benchmark
[103] 2001 financial statement: capital + retained earnings/assets
[104] From 2001 financial statement
[105] estimated for SME portfolio; return on total average portfolio for 2001 was 8.3% according to financial statements
[106] Return for total SME portfolio; on small loans return is 3.07%, on medium is 2.4%; micro portfolio, 5.84%

TABLE 9
Sberbank Branch Profitability[107]
January – March 2002

Branch	Portfolio US$ (millions)	Before Tax Profit Annualized	Return on Portfolio %	Return on Preferred Assets %
Tomsk	3.0	.43	14	6
Tula	4.1	,71	17	7
Nizhny Novgorad	3.5	.52	15	6
Kemerovo	3.2	.61	19	6
Krasnoyarsk	3.4	.60	16	7
Novokuznetsk	2.5	.45	18	6

TABLE 10
Commercial Banks Financed by U.S. EBRD SME Financing Facility
Outstanding Portfolios and Arrears
(using outstanding portfolios 9/30/02)[108]

Location	Outstanding Portfolio US$ (millions)	Outstanding Number Of Loans	Arrears > 30 days % of portfolio
Kazakhstan	64.8	15,135	.53
Georgia	1.4	401	3.05
Kyrgyz Rep.	.3	115	0

TABLE 11
Commercial Banks Financed by U.S. EBRD SME Financing Facility
Distribution of Loans by Size
(using outstanding portfolios 9/30/02)

Location	<$10,000		$10,001-$50,000		Over $50,000	
	% amt. portfolio	% no. of loans	% amt. portfolio	% no. of loans	% amt. portfolio	% no. of loans
Kazakhstan	39	88	39	10	22	2
Georgia SME	79	93	21	7	0	0
Kyrgyz Rep.	74	97	26	3	0	0

[107] Sberbank is a bank in Russia that receives EBRD funds for on-lending
[108] US/EBRD SME Financing Facility Semi-Annual Report September 2002

TABLE 12
Commercial Banks
Number of Loans Disbursed and Average Loan Size

Bank	No. of Loans Disbursed	Avg. Size of Loans	Amount Disbursed (millions)
Shorebank Programs			
Georgia SME[109]	280[111]	$45,700	$12.51
Georgia DEL[110]	383[112]	4,855	1.78
Armenia SME	56[113]	40,500	1.43
Armenia DEL	199[114]	3,679	.73
Azerbaijan SME	47[115]	32,678	1.54
Azerbaijan DEL	210[116]	10,605	2.06
EBRD EU Accession[117]	13,602[118]	$25,342	€344.70
American Bank of Kosovo (ABK)[119]	940[120]	€24,468	€ 23.0
Georgia SME[121]	401[122]	$3,513	$ 1.59
Kazakhstan Small and Micro[123]	44,365[124]	$5,845	$ 259.31[125]
Kyrgyztan[126]	115[127]	$2,479	$ .24

109 SME loans under the Shorebank Caucasus Program were larger than $10,000
110 DEL loans generally ranged from $1,000 to $10,000
111 3 commercial banks, 1998-2002
112 1 commercial bank, 1999-2002
113 3 commercial banks, 2000-2002
114 1 NGO, World Vision SEF, 1999-2002
115 3 commercial banks 1998-2002
116 Shorebank Overseas Azerbaijan 2000-2002
117 10 EU Accession countries
118 26 banks 1999-2002
119 Purchased in 2002 by RIB, a Vienna-based foreign bank
120 Outstanding October 2002
121 US/EBRD SME Financing Facility
122 January - October 2002
123 US/EBRD SME Financing Facility
124 May 1998-October 2002
125 Not allocated between small and micro; outstanding micro portfolio as of 2/28/03 was $28.2 M and outstanding small was $47.8M
126 US/EBRD SME Financing Facility
127 April to October 2002

TABLE 13
Best Practice NGO
Opportunity International
Outreach and Performance Indicators[128]

Location	No. of Clients[129]	Portfolio US$[130] (millions)	Avg. Loan Size US$	Arrears > 30 days %	Operational and Financial Sustainability %		ROA[131] %
					Operational	Financial	
Albania	1,421	2.5	1,411	1.9	107	96	1.7
Bulgaria	1,580	2.3	1,424	1.0	76	72	(2.0)
Croatia	598	2.9	4,849[132]	3.8	102	99	1.3
Montenegro	4,942	8.7	1,763	1.1	98	75	(.5)[133]
Macedonia	2616	4.1	1,572	1.1	182	167	5.8
Poland	693	1.5	2,135	2.0	107	100	(1.8)
Romania	1,081	1.3	1,240	1.5	110	88	3.3
Russia[134]	10,000	6.0	600	.44	121	84	6.5
Serbia[135]	608	1.0	1,644	0	75	60	(5)[136]

TABLE 14
Best Practice NGO
FINCA
Outreach and Performance Indicators[137]

Location	No. Village Banks	No. Clients	Outstanding Portfolio US$ (millions)	Avg. Loan Size US$	Arrears > 30 days %	ROA[138] %	ROE[139] %
Armenia	875	5,269	1.6	514	1.6	18	25
Azerbaijan	868	6,411	.6	192	0	(19)	(24)
Georgia	1,398	6,400	1.4	367	1.4	5	6
Kyrgyzstan	2,511	19,789	4.2	296	1.0	24	27
Samara	275	2,282	2.6	1,483	.7	4	4
Kosovo	239	1,795	3.5	2,371	2.2	(3)	(5)

[128] OI Network Eastern Europe Regional Report, Jan. 2003
[129] See footnote 1; refers to outstanding loans in the portfolio
[130] FY 2002 from Opportunity International Network Commercialization Plans unless otherwise noted
[131] year 2002 from Opportunity International (not audited)
[132] In 2002, average loan size was closer to $6,000 with $1.57m disbursed in 265 loans
[133] ROA lower due to bank conversion costs; ROA 2001= 8% and in 2003 4% expected
[134] For a – all figures are estimates from OI Network EE Report Jan. 2003
[135] Novi Sad – licensed at a savings bank
[136] 2003 ROA of .03 is expected
[137] As of 12/31/02; not audited
[138] ROA defined as annualized net operating margin/average assets YTD
[139] ROE defined as annualized net operating margin/average total equity YTD

TABLE 15
WOCCU Credit Unions,
Total Assets, Outstanding Portfolio, Customer Savings

Location	Total Assets US$ (millions)	Outstanding Loan Portfolio US$ (millions)	Customer Savings US$ (millions)
Bulgaria[140]	**2.8**	**2.2**	**1.5**
Romania[141]	**21.2**	**17.2**	**9.6**
Macedonia[142]	**1.0**	**.7**	**.3**

TABLE 16
WOCCU Credit Unions
Performance Indicators[143]

Location	Equity/Assets %	Portfolio/Assets %	ROA[144] %	Total Delinquency %
Bulgaria	**9.3**	**77.1**	**6.6**	**9.6**
Romania	**12.7**	**70.7**	**6.0**	**4.2**
Macedonia	**5.5**	**70.8**	**5.4**	**3.7**

TABLE 17
WOCCU Credit Unions
Outreach Indicators[145]

Location	No. Clients	No. Savings Accounts	Avg. Savings Account Size US$	No. Loans	Average Loan Size US$
Bulgaria	**12,118**	**N/A**	**139**	**4,000**	**548**
Romania	**115,004**	**64,887**	**199**	**70,475**	**244**
Macedonia	**1,909**	**3,601**	**170**	**984**	**714**

140 13 Bulgarian credit unions as of 9/30/02
141 26 Romanian credit unions as of 12/31/02
142 6 Macedonian credit unions as of 9/30/02
143 From www.woccu.org/development/md_country.php?cid=3
144 Net income/average assets
145 See note 4

TABLE 18
Growth of the Leasing Sector in Russia
By Number of Licensed Leasing Companies and Value of Equipment Financed[146]

Year	Volume of Russian Market for Leasing[147]		No. of Licensed Companies[148]	Actual No. Companies[149]
	US$ (billions)	Rubles (billions)		
1999	.4	10.6	937	N/A[150]
2001	1.7	49.7	1825	500
2002	2.3[151]	72.4[152]	N/A	550

TABLE 19
Deals and Portfolios by Leasing Company[153] **in Russia**
Years 2000-2001

Year	No. Deals	Volume of Deals per Company US$			Portfolio per Company[154] US$
	Median	Average	Median	Median Range	Median
2000	35	238.000	53,000	5,000-249.000	644,000
2001	44	169,000	58,000	7,000-308,000	987,000

[146] Leasing Development Group of the International Finance Corporation. Financial Leasing in Russia; Market Survey 2001-2002. Moscow 2002.
[147] Volume of market is measured by the value of equipment financed
[148] Estimated that only from 25% to 30% of licensed companies operate leasing companies
[149] Estimated by Leasing Development Group (LDG)
[150] Not available for 1999; for 2000 estimated at 350
[151] Forecast
[152] Forecast
[153] See Footnote 1
[154] Defined as total payments to be received

TABLE 20
Average Interest Rates Charged by Company to Lessees[155] in Russia

Year	Rates for Leases in Rubles	Rates for Leases in Hard Currency
2000	26-28% [156]	15-16%
2001	25%	14-15% [157]

TABLE 21
Direct Investments in SMEs
Small Enterprise Assistance Fund
(SEAF)
Total Investments by Number and Size

No. Total Investments In Eastern Europe[158]	Cumulative Equity Invested US$ (millions)	Avg. Equity Investment US$	Cumulative Debt Investment US$ (millions)	Avg. Debt Investment US$	Cumulative Equity and Debt Invested US$ (millions)
175	37	211,690	28.6	163,690	65.7

TABLE 22
Direct Investments in SMEs
Small Enterprise Assistance Fund
(SEAF)
Profitability on Exits

No. Exits	Total Invested Capital US$ (millions)	Realized & Residual Value US$ (millions)	Multiple of Invested Capital	Gross IRR
96[159]	31.3	39.9	1.274[160] **Annualized Return %** 4 yrs.[161] 6.24 5 yrs. [162] 4.69 7 yrs. [163] 3.52 10 yrs.[164] 2.45	8%

155 LDG p. 47. Rates for bank loans are not provided because medium and long-term loans (over one year) are hardly available.
156 In LDG survey of 114 leasing companies, maximum in survey was 42%
157 In LDG survey ranged from minimum of 4% to maximum of 22%
158 Includes investments in Poland, Bulgaria, Russia, Croatia, Macedonia, Romania. Latvia, Estonia, Lithuania
159 Includes both successes and write-offs and liquidations
160 Gross after 11 years of tracking investments
161 Median time for 96 investments with exits
162 5 yrs. Is the mode or highest frequency for duration of investment in the 96 investments with exits
163 7 yrs. Tends to be the maximum for equity investments
164 10 yrs. Is the timeframe during which all investments and exits occurred

ANNEX C

METHODOLOGY

METHODOLOGY

The purpose of this study was to gather information about various approaches to lending to micro, small and medium enterprises (MSMEs) in Eastern Europe and Eurasia, and to identify models that could be compared on twelve program characteristics. Models were identified both from the scope of work and during research as specific approaches to financing SMEs were identified. Many program characteristics involved gathering quantitative results indicative of institutional performance. Accordingly, the research focused on accessing the most reliable sources for this information. Reports and information were extracted from websites of various organizations. Some websites (WOCCU, IMI) contain current statistics, which are regularly updated, as well as statements of policies. Gathering primary data from annual reports and financial statements was given priority. Sometimes annual reports were requested directly from organizations, both by mail and during interviews.

Research methodology also involved contacting many people, including those from multilateral and donor agencies (e.g. EBRD, World Bank, IFC, IPC), commercial banks in Eastern Europe, cognizant technical officers (CTOs) in USAID Missions, personnel in the Office of Microenterprise Development at the Office of Economic Growth in the EE Bureau, implementing partners (SEAF, SAS, FINCA, OI), and the U.S. Department of Treasury. Some of these contacts involved face-to-face interviews, while others were by phone calls or electronic communication (e-mail). People contacted often sent additional primary information, such as up-to-date financial statements and recent monitoring reports. In all, over 50 contacts were made and theses resulted in about 40 substantive information exchanges.

Reports and data were carefully reviewed and appropriate information was extracted. It was summarized and presented in tables in Annex B of the report. Information contained in these tables is critical for understanding performance and facilitating comparisons of models. A comparison matrix in Annex A summarizes in narrative form information found in the tables.

ANNEX D

CONTACTS AND RESOURCES

CONTACTS

EBRD

Margaret L. Kuhlow, Treasury Attaché, Office of U.S. Executive Director
Elizabeth Wallace, Director of the Group for Small Business and Analytical Services
Charlotte Ruhe, Director EU Accession Program
Janet Young, Executive Secretary, Group for Small Business and Analytical Services
Frances Reid, Senior Banker, Direct Investment Facility
Ainura Guppy, Financial Institutions

FINCA

Marianne Benet, Senior Coordinator for U.S. Government Programs
Deborah Burand, Director of Capital Markets
Luc Vaillancourt, Relationship Manager for Multilateral and European Organizations

Republic of Georgia

Chrys Maliaras, Former Program Manager EBRD/SME Line of Credit Georgia
Downscaling

Tbiluniversal Bank

Lasha Akhaladze, Director

Bank of Georgia

Temur Abuladze, Deputy Director, Credit Department
Ed Coll, Senior Advisor, EBRD

IFC

Irma Likhachova, Communications Officer for Central and Eastern Europe
Galina Klimenko, Investment Officer Financial Markets Team, Moscow
Greg Alton, Project Officer, Central and Eastern Europe, Moscow

IPC

Bertolt Hertzfeldt, Coordinator of the Kazakhstan Small Business Program

Kazakhstan

Bryan Stirewalt, Banking Reform Expert, Bearing Point/Barents Group
Kimberly Rosen, Private Enterprise Officer, USAID/Kazakhstan

Opportunity International

Ken Vanderweele, President, Investment Services Division

Shorebank Advisory Services

Forest T. McKennie, Managing Director

Small Enterprise Assistance Funds

H.J. vander Vaart, President and CEO
Mildred O. Callear, Executive Vice President
Gentiana S. Arovas, Portfolio Information

USAID/Washington

Brad Wallach, Team Leader, Enterprise, Development and Financial Markets/EGAT
Katherine McKee, Chief, Office of Microenterprise Development/EGAT
Barry Lennon, Office of Emerging Markets/EGAT
Liza Valenzuela, Office of Microenterprise Development/EGAT
Scott Kleinberg, Office of Microenterprise Development/EGAT
Richard Johnson, Senior Advisor, Office of Economic Growth/Europe and Eurasia
David Jessee, Senior Advisor, Office of Market Transition/Europe and Eurasia
Tom Morris, Private Sector Officer, Office of Market Transition/Europe and Eurasia

U.S. Department of Treasury

Edith Boehler, Economist, Office of the Assistant Secretary for International Affairs
Nancy Katz, Desk Officer, Office of Multilateral Development Banks
Abigail Demopulos, International Economist, Office of Multilateral Development Banks

World Bank

Richard Rosenberg, Director, CGAP

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